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IN THE

Supreme Court of the United States

OCTOBER TERM 1976

No. 76-1359

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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March 31, 1977

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BANKERS TRUST COMPANY,

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SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Bankers Trust Company (hereinafter "Bankers") respectfully prays that a writ of certiorari issue to reverse the opinion and judgment of the United States Court of Appeals for the Second Circuit entered on January 3, 1977 that reversed an order of the United States District Court for the Southern District of New York dismissing the complaint for failure to state a cause of action under the anti-fraud provisions of the Securities and Exchange Act.

Opinions Below

The opinion of the Court of Appeals (A. 1-12)[1] is not as yet officially reported but is unofficially reported at CCH Fed. Securities Law Reporter at paragraph 95,823. The

[1] The numbers in parentheses ( ) prefixed by the letter "A" refer to pages of the appendix.

opinion of the District Court (A. 15-26) is reported at 407 F.Supp. 7. The memorandum opinion of the trial court, Supreme Court, New York County (A. 27-29) is not officially reported.

Jurisdiction

The judgment of the Court of Appeals was entered on January 3, 1977 (A. 13-14). The jurisdiction of this court is invoked under 28 USC § 1254(1).

Questions Presented

1. Whether a commercial bank, which had received a pledge of stock as collateral for a loan and subsequently returned the stock to the debtor upon the repayment of the loan, is subject to an action for fraud under the Securities Exchange Act on the ground that the release of the pledge constituted a sale of securities within the meaning of the Act.

2. Whether the requirement of § 10b and Rule 10b-5 that a fraud to be actionable under the Securities Exchange Act be committed "in connection with the purchase or sale of any security" is satisfied where the alleged "sale" is the release of collateral by a commercial bank of pledged stock upon repayment of its loans, and the alleged "purchase" is the subsequent pledge of the shares by a third-party.

Statutes Involved

Section 3 of the Securities Exchange Act of 1934, 15 USC § 78c(a), as amended provides in relevant part:

• • •

"(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.

(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

• • •

Section 10 of the Securities Exchange Act of 1934, 15 USC § 78j, 48 Stat. 891, as amended, provides in relevant part:

"It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 CFR (Code of Federal Regulations) § 240.10b-5 provides in relevant part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

• • •

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Statement of the Case

(a) The Facts

The facts of this case are well set forth in the opinions of the District Court (A. 15-26) and the Court of Appeals (A. 1-12) and in the opinion of Mr. Justice Nadel for the Supreme Court of the State of New York (A. 27-29). Therefore, only a short statement of facts is here necessary.

Bankers is a commercial bank. In August, 1970, Kates who is not a party to this action, applied to Bankers for a $50,000 loan (A. 17). As collateral, he pledged 40,384 shares of Equity National Industries stock to Bankers. This stock bore a legend which declared the stock subject to an Escrow Agreement and restricted transfer in accordance with the terms of the agreement. At the time the stock was pledged to Bankers, Bankers received an opinion letter from counsel that the stock would become eligible for public sale within six months. At the time of the loan, Bankers expected the loan to be repaid by Kates and the collateral returned. By March 3, 1972, the loan had been reduced to $45,000 (A. 4).

In February-March, 1972, Kates had made an agreement with Arnold and Fowler to sell to them the shares which were being held by Bankers as collateral for the outstanding indebtedness (A. 3, 17). Arnold and Fowler persuaded the plaintiffs herein, Mallis and Kupferman, to loan to Arnold and Fowler $156,000 to be borrowed from Franklin National Bank. As part of that transaction, Arnold and Fowler agreed that Mallis and Kupferman would have as security for their loan a pledge of the stock to be purchased by Arnold and Fowler from Kates. Mallis and Kupferman were to receive a profit of $50,000 on this loan within one (1) month (A. 16-17), a fact which Bankers did not then know.

Bankers was informed by Kates that Kates had obtained a purchaser for the Equity National shares and that Kates

intended to redeem his stock. A closing was held on March 3, 1972 attended by Arnold and Fowler, Kates, a representative of Franklin and Bankers' attorney (A. 4). Banker's attorney "could not and did not know of [Mallis] existence prior to the closing, which [Mallis] did not attend" (A. 29). Franklin's representative delivered three checks totalling $156,000 to Kates. Kates endorsed one of the checks in the amount of $45,000 to Bankers as a repayment of his loan made in 1970. In accordance with Sec. 9-506 of the New York Uniform Commercial Code, Bankers released and returned the stock to the original pledgor Kates. Kates sold the stock to Arnold and Fowler, who then pledged the stock to Mallis and Kupferman.

(b) Judicial Proceedings

Subsequent to this transaction, Mallis instituted lawsuits against Bankers in both State and Federal Courts, and Kupferman joined him in the Federal Court.

1. The Decision of the State Court

On December 11, 1972, Mallis instituted an action against Bankers as well as other defendants in the State Court charging Bankers with both fraud and negligence in permitting "escrowed stock" to be delivered to the possession of Kates thereby allegedly aiding and abetting a fraudulent transaction (A. 28). In dismissing the complaint, the court ruled (A. 29):

> "The leading case on where there is a duty to speak is Amend v. Hurley, 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely no relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this 'investment', the Equity shares are

called 'collateral' and he is guaranteed *repayment* out of another stock transaction.

The 'fraudulent concealment' he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend."

An order of dismissal was entered and no appeal was taken.

2. The District Court Decision

In February, 1975, Mallis and Kupferman instituted this action under Section 10b and Rule 10b-5 of the Securities Exchange Act alleging that Bankers had violated the Act by transferring the securities to the plaintiff—apparently through Kates paying off the loan and selling the securities to Arnold and Fowler, who then pledged the securities to plaintiff—in order to recover $45,000. On motion to dismiss, the court dismissed the claim against Bankers for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy (A. 24). The court reasoned that the claim was barred to (A. 21):

> "plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine. *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975). The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within

> the scope of the federal securities laws. See, e.g. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), cert. denied, 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick* (1974-75), CCH Fed. Sec. L.Rep. 94,786 (S.D.N.Y. Sept. 3, 1974)."

3. The Court of Appeals Decision

On appeal, the Court of Appeals for the Second Circuit reversed and held that "a pledge constitutes a 'contract to sell or otherwise dispose of' a security within the meaning of Section 3(14) of the 1934 Act" (A. 12). The Court expressly rejected the rationale of the United States Court of Appeals for the Fifth Circuit in *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (CA 5, 1974) cert. denied 420 U.S. 930 and relied on its earlier decisions in *SEC* v. *Guild Films Co.*, 279 F.2d 485 (CA 2) cert. denied, 364 U.S. 819 (1960) and *United States* v. *Gentile*, 530 F.2d 461 (CA 2) cert. denied —— U.S. —— (A. 9-10). In *Gentile* supra, the Second Circuit stated "To the extent that McClure . . . suggests a contrary conclusion, we disagree with it." (530 F.2d at 467) The Court held that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A. 12).

REASONS FOR GRANTING THE WRIT

In holding that a pledge of stock to a commercial bank and its return to the debtor upon the repayment of the indebtedness as required under the Uniform Commerical Code subjects the bank to a lawsuit under Section 10b and Rule 10b-5 of the Securities Exchange Act, the decision of the Second Circuit in this case conflicts with the recent decision by the Court of Appeals for the Fifth Circuit in *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490, is contrary to the principles enunciated by this court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) and raises an issue of public importance.

To fall within the scope of Section 10b of the Securities Exchange Act and Rule 10b-5, the fraud alleged by the plaintiff must be "in connection with the purchase or sale of any security." (15 USC § 78j(b)). This court has held that only a purchaser or seller of a security may maintain an action for damages under Section 10b of the Securities Exchange Act and Rule 10b-5. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). In this case, the pledge of the stock to Bankers was in August, 1970. The release of the stock to the pledgor upon the repayment of the loan was in March, 1972. Certainly the making of a pledge in 1970 antedating the return of the securities by two years had no nexus with the alleged fraudulent transaction between Mallis, Fowler and Arnold. All that is involved in this case was the release of the pledge which was in no sense a "sale" and which cannot be relied upon to fulfill the requirements of the Act to create standing.

Contrary to the court below which held that the bank becomes a "seller" of stock when it returned the stock to the pledgor—the return of the stock to the pledgor, upon repayment of the indebtedness, does not bring the transaction within the purchase or sale requirements of Section 10b and Rule 10b-5. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (CA 5, 1974) cert. denied 420 U.S. 930 (1975). In that case, the plaintiff sued a bank and its loan officer on a securities fraud theory in connection with a stock transaction which arose when, as part of a loan, the bank required plaintiff to pledge her stock as collateral. Thereafter, the bank foreclosed on the loan and liquidated the assets of the corporation rendering plaintiff's stock worthless.

The District Court dismissed the complaint on the grounds of lack of subject matter jurisdiction. The Court of Appeals affirmed the lower court's ruling that the transaction did not fall within the federal securities laws stating (497 F.2d at 495):

> "A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. A commercial bank's business is lending money not trading in securities. Cf. *Bronner* v. *Goldman*, 361 F.2d 759 (1st Cir.), cert. denied, 385 U.S. 933, 87 S.Ct. 295, 17 L.Ed.2d 214 (1966) (factor selling pledged stock not a 'broker' or 'dealer'). If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview. See 1 L.Loss, Securities Regulation 649 (2d ed. 1961)."

This rationale of the Fifth Circuit was rejected by the Second Circuit in this case.

We submit that contrary to the Second Circuit, the Fifth Circuit correctly recognized that the pledge of stock as col-

lateral for a loan did not bring the transaction within the securities laws.

State law very carefully regulates the creation of a security interest in stock in Article 9 of the Uniform Commercial Code. Uniform Commercial Code Sec. 9-305 provides for the perfection of security interest in stock without the need for filing.

Uniform Commercial Code Sec. 9-207 sets forth the rights and duties of both the debtor and the secured party, when the collateral is in a secured party's possession, including the standard of care to be followed in the preservation of the collateral and the duties to expend reasonable care in the preservation of the rights of the debtor against all other parties. Part 5 of Article 9 sets forth the rights and duties of the secured party on default, including the debtor's rights under Uniform Commercial Code Sec. 9-506 to redeem the collateral by tendering the full amount of their obligations secured by the collateral.

If Congress in enacting the securities laws had intended all transactions involving the pledge of stock to come within the Act and not be governed by state law, it would have said so. The mere fact that securities are involved in the transaction does not automatically bring the transaction within the standing requirements of Section 10b and Rule 10b-5 and permit the action to be brought in Federal Court. See *United Housing Foundation* v. *Foreman*, 421 U.S. 837, 849 (1975) footnote 14, where this Court reversed the Second Circuit's expanded and "literal approach" to the Act by noting the Fifth Circuit's decision in *McClure*. Certainly Congress did not intend to federalize the substantive law involving the pledge of stock as collateral merely because the transaction involved securities where, as here, " 'the cause of action was one traditionally relegated to state law. . . .' " See *Piper* v. *Chris-Craft Industries, Inc.*, 45 U.S.L.W. at 4192 quoting *Cort* v. *Ash*, 422 U.S. at 78, *Santa Fe Industries, Inc.* v. *Green*

(—— U.S. ——), decided March 23, 1977. In enacting the Securities Exchange Act of 1934, Congress stated that its purpose was to provide for the regulation of "securities exchanges and over-the-counter markets" operating in interstate and foreign commerce and through the mails to prevent inequitable and unfair practices on such exchange. 15 U.S.C. § 78b, 48 Stat. 881 as amended. Congress did not intend to include ordinary commercial transactions involving stock under the umbrella of the act, especially as here where Congress did not expressly provide a private cause of action for violations of Section 10b. *Sante Fe Industries* v. *Green*, —— U.S.L.W. ——, supra.

As noted in 1 Loss, Securities Regulations (2d ed. 1961) 645 at Footnote 13:

> "The Act as introduced and as passed by the Senate expressly exempted sales 'by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of this Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such a debt.' H.R. 4314 and S.875, 73d Cong., 1st Sess. (1933) 12(b)."

Loss noted that "the elimination of this section" in the final bill did not seem too significant, because in many instances the exemption in the original bills for isolated transactions by non-dealers 12(c), which was narrower than the first clause of 4(1) as adopted, "would not have extended to liquidating transactions by a pledgee." *Ibid.*

Similarly the Commission itself did not consider a pledge of collateral to be a sale until after the decision of the Second Circuit in *SEC* v. *Guild Films*.

Ignoring the legislative history and the Commission's earlier interpretation, the Second Circuit in this case erroneously held that the return of pledged stock to the pledgor was a sale of stock relying on its earlier decisions

in *Gentile* and *Guild*. In *U.S.* v. *Gentile*, 530 F.2d 461, 467 (CA 2, 1976) the Second Circuit held that the pledge of fraudulent securities to borrow monies was a sale by the fact that the Act was intended "to protect defrauded lenders just as much as [it was intended to protect] defrauded buyers." In *SEC* v. *Guild Films*, 279 F.2d 485 (CA 2, 1960) *cert. denied sub nom. Santa Monica Bank* v. *SEC*, 364 U.S. 819, the Court said that the bank became an underwriter when it liquidated the collateral as soon as it was received. Neither *Gentile* nor *Guild* involves, as this case does, an ordinary run of the mill pledge of securities to secure a loan which the debtor had contracted to repay and was expected to be repaid and part of which was repaid by the debtor. In those cases, the pledge of stock was not bona fide, but was merely intended as a means to distribute stock. If *Guild* and *Gentile* stand for the proposition that a pledgee's foreclosure sale may in some circumstances satisfy the requirements of Sec. 10b and Rule 10b-5, then even so, those cases do not establish the propositions advanced by the Second Circuit in this case that the mere release of a pledge upon repayment of a debt constitutes a "sale" when none of the indicia of a sale transaction are present.

The importance of this question is plainly demonstrated by the fact that commercial banks regularly receive the pledge of stock as security for loans as a daily occurrence. Securities pledged to banks throughout the United States run into the billions of dollars. Each of these loans and pledges should continue to be governed by state law.

As noted in *Santa Fe Industries* v. *Green, supra*, the plaintiffs and "others in [their] situation [should be relegated] to whatever remedy is created by state law."[2]

[2] The importance of obtaining judicial review is further demonstrated by the fact that Mallis should not be permitted to transform an unsuccessful state law fraud claim to a Federal claim

(footnote continued on following page)

Indeed if every case involving the pledge of securities would come within the Act, the Federal Courts would be burdened by a plethora of litigation involving the debtor and the bank when the loan goes bad and the debtor has pledged securities which are either sold or diminished in value as a result of shifts in the stock market.[3] If all loans collateralized by securities become subject to federal securities laws, it will render difficult the ability of borrowers to obtain credit from banks on the basis of their pledge of stock as collateral. Judicial review of so important a question as this is plainly warranted.

Professor Loss pointed out (1 Loss *ibid.* at 645) that the status of the foreclosure sales by pledgees "was unsettled by the Second Circuit decision of May, 1960 in the *Guild Films* case." Until then it had been generally considered that "a *bona fide* pledge [as here where it had taken place two years before] did not involve an 'offer' or 'sale' and that, in any event, a foreclosure sale by a *bona fide* pledgee

(footnote continued from preceding page)

under Rule 10b-5 merely by asserting a cause of action in Federal Court that has already been decided adversely to him in State Court. Section 10b of the Act does not concern itself with fraud per se as much as it is the effect of fraud upon investors and the public interest in free and open trading. The rights and remedies provided by the Securities Exchange Act are to serve "in addition to any and all other rights and remedies that may exist at law or in equity." Securities Exchange Act of 1934, Section 28(a), 15 USC Section 78bb. The decision adverse to Mallis by Justice Nadel in State Court is consistent with the Supreme Court of California in *Goodman* v. *Kennedy*, Security Law Reporter Section 95,829. In that case, the California Supreme Court held in a similar situation, as did Justice Nadel, that an attorney was not liable for failing to disclose facts which might indicate the possibility of such adverse consequences on sale of securities to the plaintiff's attorney in conversations discussing the proposed sale.

[3] See *Brodheim* v. *Chase Manhattan Bank*, 75 Misc. 2d 394, 347 N.Y.S.2d 394 (Sup. Ct. N.Y. 1973); *American Bank and Trust Company* v. *Lichtenstein*, 45 A.D.2d 790, 369 N.Y.S.2d 155 (1st Dept. 1975); *Smith* v. *Security National Bank*, 175 N.Y.L.J. p. 7, col. 1., and *Grace* v. *Sterling Grace & Co.*, 30 A.D.2d 61, 289 N.Y.S. 2d 632 (1st Dep't 1968).

of securities deposited as collateral • • • was exempt" under the law (Loss, *ibid.*). The Second Circuit decided an important question in the words of Professor Loss "with all its implications to the world of commercial banking" without considering the ramifications. 1 Loss *Ibid.* at 648. Loss noted soon after the Guild Films decision that as a result of the court's decision "the country's banks and their lawyers must guess whether another court • • • will limit *Guild Films* to its facts or whether the court's broad language will be taken as laying down the law with respect to pledges generally." Loss *Ibid.* at 649.

If this decision stands, the guesswork has now ended in the Second Circuit which held that any pledge of stock is subject to the Securities Act, whether or not the pledge was in connection with the allegedly fraudulent act. This decision is wrong and in plain conflict with the Fifth Circuit. Judicial review is required.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Of Counsel:

CHARLES LEEDS

March 31, 1977

Opinion of the Court of Appeals.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 26—September Term, 1976.

(Argued October 18, 1976 Decided January 3, 1977.)

Docket No. 76-7166

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Defendants-Appellees.

Before:

SMITH, OAKES and TIMBERS,

Circuit Judges.

Appeal from judgment entered in the Southern District of New York, Milton Pollack, *District Judge,* 407 F.Supp. 7, dismissing complaint for failure to state claims upon which relief can be granted and denying leave to amend complaint in action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System and of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Affirmed as to dismissal of Regulation U claim; as to dismissal of Securities Exchange Act claim, reversed and remanded with directions.

NOEL W. HAUSER, New York, N.Y. (Hauser & Rosenbaum, New York, N.Y., on the brief), *for Plaintiffs-Appellants.*

JACK H. WEINER, New York, N.Y. (Charles Leeds, New York, N.Y. on the brief), *for Defendant-Appellee Bankers Trust Company.*

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ROBERT S. ANDERSON, New York, N.Y. (Hughes Hubbard & Reed, New York, N.Y., on the brief), *for Defendant-Appellee Franklin National Bank.*

TIMBERS, *Circuit Judge:*

This appeal is from a judgment entered in the Southern District of New York, Milton Pollack, *District Judge*, 407 F.Supp. 7, dismissing the complaint for failure to state claims upon which relief can be granted and denying leave to amend the complaint in an action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221 (1976), and alleged violations of the antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1976).

The essential questions which we find presented and our rulings thereon are as follows:

(1) Whether a bank loan to appellants by Franklin National Bank was subject to Regulation U.
We hold that it was not.

(2) Whether appellants as pledgees of stock certificates of Equity National Industries, Inc. have standing to sue under Section 10(b) and Rule 10b-5.
We hold that they do.

For the reasons below, we affirm the dismissal of the Regulation U claim against European-American Bank & Trust Company and Franklin National Bank; but as to the dismissal of the Securities Exchange Act claim against the Bankers Trust Company, we reverse and remand with directions.

I. FACTS

Appellants Mallis and Kupferman are dentists.[1] Between March 1 and March 3, 1972 Jack J. Arnold, an attorney, persuaded them to make a short term loan of $156,000 to himself and his client, John B. Fowler, to finance the purchase of 40,034 shares of stock in Equity National Industries, Inc. (Equity National). The consideration to appellants was to be $50,000. In addition, appellants were to receive possession of the Equity National stock certificates as collateral. To fulfill their part of the

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[1] We assume familiarity with the comprehensive statement of facts in the district court opinion. 407 F.Supp. at 9-10.

agreement, appellant immediately obtained a loan of $156,000 from appellee Franklin National Bank (Franklin National). The parties dispute whether this loan was to have been secured in turn by the Equity National certificates. This issue was not resolved by the district court.

Title to the Equity National shares desired by Arnold and Fowler was in Jerome and Judith Kates. But the certificates were in the possession of the Bankers Trust Company (Bankers Trust), to which the Kateses had pledged the shares as collateral for a loan. The Kateses still owed $45,000 on this loan on March 3, 1972.

The shares, which the Kateses had acquired pursuant to a merger between a corporation under their control and Equity National, were subject to an escrow agreement which required the return of the certificates to Equity National for cancellation or reissue depending on whether the acquired corporation met specified earnings conditions. Each certificate bore a legend which declared it to be subject to the escrow agreement and restricted transfer except in accordance with the terms of the agreement. Although other Equity National shares of the same series were registered under the Securities Act of 1933 and listed on the American Stock Exchange (Amex), the shares issued to the Kateses were not.

By a letter to Bankers Trust, Equity National had recalled the Kateses' shares for cancellation in March 1971. As a result the shares were worthless when the transactions here at issue occurred in March 1972.

A closing was held on March 3, 1972. Arnold and Fowler, the Kateses, and representatives of Franklin National and Bankers Trust were in attendance, but not appellants. Franklin National's representative delivered three checks totalling $156,000 to the Kateses. The Kateses endorsed one of the checks in amount of $45,000 to Bankers Trust. Bankers Trust then released the Equity National Certificates. The Kateses transferred the certificates to Arnold

and Fowler who subsequently delivered them to appellants in accordance with the loan agreement.

The instant action arises from the failure of Arnold and Fowler to repay their loan from appellants. In the district court appellants sought to assert two claims. First, they sought relief against Franklin National, now insolvent, and the European-American Bank & Trust Company (European-American), which purchased appellants' note along with Franklin National's other assets.[1] They sought rescission of their loan from Franklin National on the ground that the loan was made for the purpose of acquiring margin stock in an amount in excess of the maximum loan value of the stock in violation of Regulation U.[2] Second, they alleged that Bankers Trust violated the Securities Act of 1933 in disposing of the unregistered Equity National shares in the course of terminating their pledge agreement with the Kateses. During the course of proceedings in the district court appellants departed from this theory, which apparently looked to Section 12(1) of the 1933 Act, 15 U.S.C. § 771(1)(1970), and requested leave to amend their complaint to state a cause of action under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

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[1] The successors in interest to insolvent Franklin National are European-National and the Federal Deposit Insurance Corporation (FDIC).

As the receiver of Franklin National, FDIC was named in the complaint as a defendant with respect to appellants' Regulation U claim. Appellants since have stipulated to dismissal of their action against FDIC. Although Franklin National remains as a party, appellants no longer seek a money judgment against it.

[2] The complaint also alleged a pendant claim against Franklin National based on common law fraud. After dismissing appellants' federal claim against Franklin National, the district court dismissed the pendant claim for lack of subject matter jurisdiction and denied leave to amend it to assert a cause of action against Franklin National under the Securities Exchange Act. Appellants since have stipulated to the dismissal of both of these claims.

The theory underlying their claim against Bankers Trust is that it knowingly misrepresented that the certificates no longer were subject to the escrow agreement.

European-American, Franklin National and Bankers Trust moved to dismiss the complaint for failure to state claims upon which relief can be granted. The court granted the motions and dismissed the complaint in its entirety. In granting the motions of European-American and Franklin National to dismiss the Regulation U claim, the court held that Franklin National's loan was not made for the purpose of carrying or purchasing margin stock within the meaning of Regulation U. In granting the motion of Bankers Trust to dismiss, the court held that appellees, as pledgees, were not "purchasers" of securities and therefore could not state a claim under the 1933 Act. For the same reason the court denied leave to appellants to amend their complaint to allege a claim under Section 10(b) of the 1934 Act and Rule 10b-5.

From the judgment dismissing the complaint and the order denying leave to amend, this appeal has been taken.[4]

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[4] Appellants' notice of appeal filed March 24, 1976 is "from the Order and Judgment of the HON. MILTON POLLACK".

Judge Pollack's opinion ordering dismissal of the complaint was filed September 30, 1975. On December 5, 1975, on motion of appellants' counsel, the judge filed a Rule 54(b) certificate directing the entry of a final judgment with respect to all defendants except FDIC so as to permit the instant appeal. We note that Judge Pollack's Rule 54(b) certificate complies with the approved practice in this Circuit that the required determination that there is no just reason for delay "ought not to be made as a matter of rote". *Arlinghaus* v. *Ritenour*, —— F.2d ——, —— (2 Cir. 1976), slip op. 239, 243 (October 26, 1976); *Gummer* v. *Shearson, Hammill & Co., Inc.*, 516 F.2d 283, 286 (2 Cir. 1974). Judge Pollack's finding that "[t]here is no just reason for leaving the claim against FDIC hanging in limbo and creating piecemeal appellate litigation" produced the additional therapeutic result of appellants' dismissal of their action against FDIC. See note 2, *supra*.

(footnote continued on following page)

The district court dismissed appellants' Regulation U claim for rescission against European-American and Franklin National on the ground that Regulation U does not apply to the loan in question. 407 F.Supp. at 10-11. We agree.

Regulation U prohibits banks from extending credit,

> "directly or indirectly . . . for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral. . . ." 12 C.F.R. § 221.1(a) (1976).[5]

The only definition of "margin stock" set forth in Regulation U which even approaches applicability to the instant shares is that of "a stock registered on a national securities exchange". 12 C.F.R. § 221.3(v) (1).[6] Although other shares

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(footnote continued from preceding page)

However, since "[e]very good case requires a mystery document", *Westchester Fire Insurance Company* v. *Tantalo*, 273 F. Supp. 7, 12 n. 5 (D. Conn. 1967), it appears that the mystery document here is the judgment itself. Our search of the voluminous appendix and original district court record has failed to uncover any document that looks like a judgment. Since the parties and the district court have proceeded on the assumption that there was an adjudication of dismissal, we decline to stand on the technicality of the missing mystery document in this case.

[5] "Maximum loan values" are set forth in 12 C.F.R. § 221.4 (1976).

[6] 12 C.F.R. § 221.3(v) (1976) defines "margin stock" as:

> ". . . (1) a stock registered on a national securities exchange, (2) an OTC margin stock, (3) a debt security (i) convertible with or without consideration, presently or in the future, into a margin stock, or (ii) carrying any warrant or right to subscribe to or purchase, presently or in the future, a margin stock; (4) any such warrant or right, (5) any security issued by an investment company licensed under the Small Business Investment Company Act of 1958 . . . registered pursuant to section 8 of the Investment Company Act of 1940 . . . unless at least 95 percent of the assets of such company are continuously invested in exempted securities."

of the same series were listed on the Amex, the particular Equity National shares here in question were not listed on any national securities exchange. They therefore were not "margin stock" so as to trigger the application of Regulation U to the Bankers Trust loan.[1]

Moreover, appellants were neither "purchasing" nor "carrying" stock within the meaning of Regulation U. 12 C.F.R. § 221.1(a), *supra*. The Regulation specifically brings within its ambit credit extended to a bank customer engaged "principally, or as one of the customer's important activities, in the business of extending credit for the purpose of purchasing or carrying margin stocks. . . ." 12 C.F.R. § 221.3(g) (1976). Under the circumstances of this case, we construe this provision to state conditions which must be met before the Regulation will apply to an intermediate borrower who reloans the funds to enable another to purchase stock. Appellants, the intermediate borrowers here, had an independent interest in the transaction and bore an independent risk. We therefore need not decide whether we would construe § 221.3(g) otherwise if the intermediate loan were a sham entered into to circumvent the Regulation's application. Since borrowing for the purpose of relending to enable others to purchase or carry margin stock was not one of appellants' "important activities", we hold that Regulation U does not apply to the Franklin National loan.

Furthermore, European-American would be insulated from appellants' rescission claim even if Regulation U were applicable here. Section 29(c)(2) of the 1934 Act, 15 U.S.C. § 78cc(c)(2) (1970), bars construction of the Act or any regulation promulgated under it to afford a defense against "the collection of any debt . . . by any person who

[1] We agree with the district court's holding that the fact that other shares of the same series were listed on the Amex does not alter the result. 407 F.Supp. at 10-11.

shall have acquired [it] in good faith for value and without actual knowledge of the violation" of the Act or regulation. Regulation U was promulgated pursuant to Section 7 of the 1934 Act, 15 U.S.C. § 78g (1970). European-American's payment of value for appellants' obligation, its good faith, and its lack of actual knowledge of any underlying irregularity are not disputed. Accordingly, even if Regulation U were otherwise applicable, we hold that Section 29(c)(2) would bar appellants from asserting their rescission claim against European-American.

III. Securities Exchange Act Claim

This brings us to what we regard as the chief question in the case: whether appellants have standing to sue under Section 10(b) of the 1934 Act and Rule 10b-5. Specifically, the issue is whether under the definition of "sale" in Section 3(14) of the 1934 Act, 15 U.S.C. § 78c(14) (1970), a pledge fulfills the familiar requirement that the fraud occur "in connection with the purchase or sale" of a security.

In resolving the standing question against appellants, the district court relied on *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5 Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). There the court acknowledged that a pledgor might be liable for fraud under Section 10(b) after his default and a consequent sale of the securities by the pledgee, but held that the pledge itself did not constitute a "sale". At the time of the decision below in the instant case, the district court did not have the benefit of our subsequent decision which rejected the rationale of *McClure* in a case arising under Section 17(a) of the 1933 Act. *United States* v. *Gentile*, 530 F.2d 461 (2 Cir.), *cert. denied*, —— U.S. —— (1976). We hold that *Gentile* and our earlier decision in *SEC* v. *Guild Films Co.*, 279 F.2d 485

(2 Cir.), *cert. denied*, 364 U.S. 819 (1960), control here and require that appellants be granted standing.

In *Guild Films* we held a pledge of stock to be a "sale" within the meaning of Section 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1970),[8] in the context of determining that the pledgees there involved were "person[s] who [have] purchased from an issuer" within the meaning of the definition of "underwriter" in Section 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1970). *SEC* v. *Guild Films Co., supra*, 279 F.2d at 489.[9] *Gentile* reaffirmed and expanded this holding. The defendant there was charged with a conspiracy to pledge fraudulently issued securities in violation of Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970). We again held a pledge to constitute a "sale" within Section 2(3), this time to satisfy the requirements of Section 17(a) that the fraud occur "in the offer or sale of any securities". *United States* v. *Gentile, supra*, 530 F.2d at 466-67. We held:

> "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute." *Id.* at 467.[10]

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[8] Section 2(3) defines a "sale" to include "every contract of sale or disposition of a security or interest in a security for value."

[9] We reasoned that the term "purchaser", "although not defined in the Act, should be interpreted in a manner complementary to 'sale'." *SEC* v. *Guild Films Co., supra*, 279 F.2d at 489.

[10] In rejecting the distinction drawn in *McClure* between the pledged shares while in the pledgee's possession and the same shares after a sale due to the pledgor's default, we stated:

> "We see no reason to make the character of the initial pledge dependent upon subsequent events." *United States* v. *Gentile, supra*, 530 F.2d at 467 n. 6.

The fact that *Gentile* was a criminal case in which civil standing was not an issue does not diminish its persuasion as a precedent with respect to the Section 10(b) claim before us. The existence of a "sale" is as essential to a criminal prosecution for violation of Section 17(a) as it is to a civil action under that section. We find no basis on the face of either the 1933 Act or the 1934 Act for denominating a pledge as a "sale" for criminal but not for civil purposes.

Nor would the standing policy enunciated by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), support such a conclusion. We recognize that the Court there expressed concern about vexatious suits by a potentially limitless class of plaintiffs. We further recognize that the granting of standing to pledgees creates potential plaintiffs where none might have existed. But a closer look at *Blue Chip* demonstrates that the specific concerns there expressed by the Court have no bearing on the question before us of granting standing to pledgees. The Court in *Blue Chip* had before it a plaintiff who claimed that the defendant's misrepresentations caused it to refrain from purchasing securities. The Court observed that the rule of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2 Cir.), *cert. denied*, 343 U.S. 956 (1952), requiring a purchase or sale, had the virtue of excluding a class of plaintiffs who had not dealt in the security at all and whose cases as a result would stand or fall on oral testimony. Requiring that the plaintiff have "dealt in" the security would assure that each case stand upon at least one "objectively demonstrable fact." *Id.* at 746-47. A pledge which occurs pursuant to a loan contract is just as concrete a transaction as is a normal transfer of title.[11]

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[11] Bankers Trust seeks to distinguish *Gentile* and *Guild Films* from the instant case on the further ground that neither of the pledges involved in those cases were bona fide. We fail to see

(footnote continued on following page)

Opinion of the Court of Appeals.

We believe that the rationale underlying our holding in *Gentile* with respect to Section 2(3) and 17(a) of the 1933 Act is persuasive authority for holding that a pledge constitutes a "contract to sell or otherwise dispose of" a security within the meaning of Section 3(14) of the 1934 Act. Accordingly, on the facts of this case, we hold that both a "sale" and a "purchase" may be cognizable under Section 10(b) of the 1934 Act. Appellants were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge.

We therefore reverse the dismissal of appellants' Securities Exchange Act claim and remand the case to the district court with directions to grant leave to appellants to amend their complaint in accordance with this opinion. See *Rogers* v. *White Metal Rolling & Stamping Corp.*, 249 F.2d 262 (2 Cir. 1957), *cert. denied*, 356 U.S. 936 (1958).[12]

Affirmed as to the dismissal of the Regulation U claim against European-American and Franklin National; but as to the dismissal of the Securities Exchange Act claim against Bankers Trust, reversed and remanded with directions to grant leave to appellants to amend their complaint in accordance with this opinion.[13]

(*footnote continued from preceding page*)

what connection the pledgor's state of mind has with the question whether the pledgee has standing to sue. Such a distinction would be at odds with our rationale in *Gentile*.

[12] Bankers Trust also contends that the dismissal of an earlier common law fraud action brought against it and others by appellants in the New York state courts should have a collateral estoppel effect so as to bar appellants' claim under Section 10(b). This defense is a matter for trial which we do not reach now. But see *Herendeen* v. *Champion International Corp.*, 525 F.2d 130 (2 Cir. 1975).

[13] Having given due consideration to the motion by counsel for European-American for an award of attorneys' fees and double costs, we deny it.

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the third day of January one thousand nine hundred and seventy-seven.

Present: Hon. J. Joseph Smith
Hon. James L. Oakes
Hon. William H. Timbers
Circuit Judges,

76-7166

Samuel Mallis and Franklin Kupferman,

Plaintiffs-Appellants,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged and decreed that the order and judgment of said

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit.

District Court be and they hereby are affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court with costs to be taxed aaginst the plaintiffs-appellants in favor of defendant-appellee European American Bank & Trust Company and against defendant-appellee Bankers Trust Company in favor of plaintiffs-appellants.

A. Daniel Fusaro
Clerk

by Arthur Heller
Deputy Clerk

Decision of the District Court.

UNITED STATES DISTRICT COURT
Southern District of New York

75 Civ. 909 (MP)

Memorandum

#43153

Samuel Mallis and Franklyn Kupferman,

Plaintiffs,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants.

Appearances:

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MILTON POLLACK, District Judge.

Federal Deposit Insurance Corporation (FDIC hereafter) and European American Bank (EA) are successors in interest to an insolvent, Franklin National Bank (FNB).

Plaintiffs, two dentists, borrowed $156,000 from FNB on March 3, 1972, and now claim that the loan (reduced substantially by repayments on account) violated Regulation U (Federal Reserve Regulations 12 CFR Section 221.1 et seq.) prohibiting loans secured by margin stock in an amount in excess of the prescribed maximum loan value of the stock. Plaintiffs contend in their first claim for relief that the loan was made for the purposes of carrying or acquiring margin stock and is therefore void and that it should be declared that they are not liable thereon.

Since the loan was neither directly nor indirectly made for the purpose of carrying or purchasing "margin stock" or being secured thereby nor were the arrangements with plaintiffs interposed as a subterfuge for avoidance of Regulation U by FNB, the first claim fails to state a claim on which federal relief may be granted.

Plaintiffs, Mallis and Kupferman, arranged the loan from FNB based solely on their signatures to a loan agreement. Their purpose was to take advantage of a business opportunity which they hoped would yield them a $50,000 profit. The opportunity involved the loan by them of money to one Fowler and his attorney Arnold on the obligation to repay the same on certain conditions with a $50,000 bonus or profit for the accommodation. Fowler had made a deposit toward the purchase of 40,000 shares of Equity National Industries, Inc., and needed more funds in order to complete the purchase. The shares were held by Bankers Trust Company, a defendant herein, as collateral for a loan to the shares' owners, Jerome and Judith Kates, who were the sellers in the transaction with Fowler.

The shares were unregistered, but Arnold is alleged to have represented to Mallis that they would become marketable in the near future because of a new rule promulgated by the Securities Exchange Commission. The shares if marketable would have, according to plaintiffs, been worth at least $400,000.

In actuality, the shares were subject to a restriction that ultimately made them worthless. They had been issued to the Kates pursuant to the agreement by which a company called Take-Two, Inc. was merged into a subsidiary of Equity. The two certificates for the shares bore legends indicating that the shares had not been registered under the Securities Act and could not be transferred except in accordance with an escrow agreement to which they were subject. Under the escrow agreement, depending on whether specified earnings conditions for the prior business of Take-Two were met for specified years, the shares would be returned to Equity to be either cancelled or reissued without the restrictive legend referring to the escrow agreement.

By letter of March 1, 1971, Equity wrote to Bankers Trust, which held the shares as collateral on an August 1970 loan to the Kates, indicating that the earnings requirement had not been met for 1970 and requesting that the Equity shares issued to the Kates be delivered to

Equity in accordance with the escrow agreement. Bankers Trust declined to do so. Equity brought suit in New York to obtain a cancellation of the shares but the suit did not proceed to a judicial determination. Equity ultimately brought suit in Delaware state court in May 1974 to obtain or to void the certificates of stock, naming the plaintiffs, the Kates, and FNB as defendants, but not Bankers Trust. This suit also did not go to judgment. Plaintiffs allege that the shares are now worthless, and indeed were worthless at the time of the Mallis-Arnold-Kates agreement culminating in their sale. At the closing of the sale, the funds transferred to Kates as consideration for the stock were turned over to Bankers Trust in payment of the outstanding indebtedness of the Kates to Bankers Trust. Bankers Trust then released the stock. Plaintiffs took the shares as collateral for their loan to Arnold and Fowler and now hold them after default by those borrowers.

Plaintiffs, as noted *supra*, seek to cancel their own indebtedness to FNB and its successors by alleging that the loan to them was in violation of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221.1 *et seq.*, as having been secured by stock for the purpose of purchasing or carrying "margin stock" in an amount in excess of the prescribed maximum loan value of the collateral.

Plaintiffs' allegations on this point fall short of adequacy in at least two ways, even assuming *arguendo* that they have sufficiently alleged that the loans were secured by stock. *Cf. Freeman* v. *Marine Midland Bank-New York*, 494 F.2d 1334 (2d Cir. 1974). The shares in question here were not "margin stock" within the meaning of Regulation U, and there was no loan for the purpose of purchasing stock within the meaning of that regulation.

The only definitional category of margin stock which arguably applies to the certificates of Equity common stock

involved herein is that of stock "registered on a national securities exchange". It appears that listed shares of Equity common stock were in fact registered and traded on an exchange at the time of the transaction herein. However those shares here involved were neither registered nor listed on a national securities exchange.

EA and FDIC have introduced the listing application submitted to the American Stock Exchange by Equity for the listing of a number of categories of common stock including "175,000 additional shares of its common stock, *upon official notice of issuance*, which represent the maximum number of shares which the Company may be obligated to issue to the former shareholders of Take-Two, Inc. . . . if the earnings of the business formerly conducted by such company reach certain specified levels." (emphasis added) (Exhibit A to Howard affidavit, May 16, 1975).

In order for such shares to have been actually listed, Equity would have had to formally notify the Exchange that the conditions had been met, a "registration authorization" indicating the number of shares would have had to be prepared by the Exchange, and a listing fee would have had to be paid by Equity. A review of the American Stock Exchange file indicated that none of these steps had ever been taken, and that the shares were never listed, which is hardly surprising given Equity's efforts to have the shares returned to it. (*See* Howard affidavit, *supra*, ¶¶ 3 and 4).

Contrary to plaintiffs' assertions, shares of stock are not "registered" on a securities exchange within the meaning of Regulation U when they are not themselves listed merely because other shares of their class are listed. *See* Published Interpretations of the Board of Governors of the Federal Reserve System, ¶ 6440 (1971) (Regulation U not applicable to loan to purchase newly issued stock during initial over the counter trading period prior to the stock "becoming registered (listed) on a national securities

exchange"). The opinion letter of an attorney for the Board of Governors submitted to this Court by the plaintiffs is not dispositive here since the question the attorney was answering is not on point with the issue in contention. Since the Equity shares purchased from the Kates were not registered on a national securities exchange and fit into no other category set out in Regulation U, they were not "margin stock" within that regulation's meaning.

Regulation U bars a grant of credit directly or indirectly secured by any stock for the *purchase* or carrying of margin stock. EA and FDIC argue that the only situation in which Regulation U applies to loans made to a borrower who in turn relends the funds to a third person for the purchase of stock is if the initial borrower is engaged principally or as one of his important activities in the business of extending credit for the purpose of purchasing margin stock. *See* 12 C.F.R. § 221.3(q). They argue that if Regulation U applied to every loan of the type in this case, 12 C.F.R. § 221.3(q) would be superfluous.

It may well be that Regulation U would nevertheless be applicable if the initial borrower were simply interposed as a subterfuge for a bank's avoiding the regulation but that is plainly not the situation here. Plaintiffs were clearly more than nominal intermediaries between FNB and Arnold in light of their own prospective profit. Thus, it cannot be fairly argued that the loan by FNB to the plaintiffs was made for the purpose of purchasing stock within the meaning of Regulation U, even though the funds were ultimately used by Arnold to purchase stock.

As a second claim for relief, plaintiffs allege a pendent claim against FNB based on allegations of common law fraud consisting of alleged misrepresentations of an officer of FNB to the effect that he had reviewed the transaction and that it was regular in all respects. Since there is no federal basis for this suit, there being no Regulation U claim, there is no basis for pendent jurisdiction and the

second claim must therefore be dismissed. Leave to amend to assert this claim under Rule 10b-5 of the Rules and Regulations promulgated pursuant to Section 10b of the Securities and Exchange Act of 1934, as amended, will be denied as unavailing to plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine, *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975).

The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within the scope of the federal securities laws. *See, e.g., McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied* 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick*, [1974-75] CCH Fed. Sec. L. Rep. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974). Thus, even if the FNB loan to Mallis and Kupferman were secured by a pledge of the Equity stock, which is disputed by EA and FDIC, plaintiffs could still not state a claim entitling relief under Rule 10b-5 on that basis since no purchase or sale was involved.

Similarly, there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in question. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize the transaction as a purchase of the stock by plaintiffs are not convincing. To allow persons in plaintiffs' situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under that rule to an extent uncalled for by the words of the rule or the statute. *Cf. Bolger* v. *Laventhol, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 267 (S.D.N.Y. 1974).

The third claim seeks relief only against Bankers Trust Company for orally asserting that the stock certificates were no longer subject to the restrictive legend thereon tieing them to an escrow agreement while allegedly having knowledge that the certificates were void.

While this third claim is predicated on fraud under the Securities Act of 1933, as amended, no federal claim is asserted on which relief may be granted since plaintiffs were not "purchasers" of the securities. For the same reason, plaintiffs' offer to amend their complaint to assert a claim under § 10 of the Securities Exchange Act based on this allegation would be unavailing; permission to so amend is denied.

With respect to their offer to amend this third claim, plaintiffs claim that strict adherence to the *Birnbaum* purchaser-seller requirement for 10b-5 suits is no longer mandated in light of the holding in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). This claim is unpersuasive in light of the fact that the plaintiff in *Bankers Life* (the liquidator of Manhattan Casualty Co.) was clearly within the scope of the *Birnbaum* rule. *See Haberman* v. *Murchison*, 468 F.2d 1305, 1311 n.5 (2d Cir. 1972).

In *Bankers Life* the Supreme Court recognized that creditors of a corporation in the process of being liquidated have an interest in a suit brought by the liquidator, but the Court carefully added that

> . . . the fact that creditors of the defrauded corporate buyer or seller may be the ultimate victim does not warrant disregard of the corporate entity . . . The crux of the present case is that *Manhattan* [the corporate seller] suffered an injury as a result of deceptive practices touching *its* sale of securities as an investor. *Bankers Life, supra*, at 12-13 (emphasis added)

Opinions in the Second Circuit since *Bankers Life* have reaffirmed the vitality of the *Birnbaum* purchaser-seller doctrine except in a few narrow and irrelevant categories of cases. *Haberman, supra; International Controls Corp.* v. *Vesco*, 490 F.2d 1334, 1343, 1346 n.16 (2d Cir. 1974); *Petersen* v. *Federated Development Co.*, 387 F. Supp. 355, 358 (S.D.N.Y. 1974); *Gurvitz* v. *Bregman*, 379 F. Supp. 1283, 1286 (S.D.N.Y. 1974); *Davidge* v. *White*, 377 F. Supp. 1084, 1087 (S.D.N.Y. 1974); *Goodall* v. *Columbia Ventures, Inc.*, 374 F. Supp. 1324, 1329 (S.D.N.Y. 1974).

Leave to join Arnold and Fowler as involuntary parties pursuant to Rule 19 of the Federal Rules of Civil Procedure is also denied.

Rule 19(a) provides that

> [a] Persons to be Joined if Feasible. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest. . . .

None of the requirements of this Rule are satisfied by plaintiffs' request. In the absence of Arnold and Fowler "complete relief" can be "accorded among those already parties." Dismissal of this action would in no way "impair or impede" the ability of Arnold and Fowler to "protect their interests," nor would it "leave any of the persons already parties subject to a substantial risk of in-

curring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest."

The general rule is that if the merits may be determined without prejudice to the absent party, the Court "will strain hard to reach that result." *Bourdieu* v. *Pacific Oil Co.*, 299 U.S. 65, 70 (1936); *Charron* v. *Meaux*, 60 F.R.D. 619, 622 (S.D.N.Y. 1973).

FDIC has joined in the motion to dismiss submitted by EA and FDIC and EA have submitted a joint brief setting forth their discussion on the viability of the complaint. The positons of those two defendants are identical on these issues. The motion is granted. The first claim is dismissed for failure to state a federal claim upon which relief can be granted. The second claim is a common law claim pendent for jurisdiction on the first claim and is consequently dismissed for lack of subject matter jurisdiction over it.

Bankers Trust submitted two affidavits to the Court urging dismissal of the third claim in the complaint which is asserted against it alone. The plaintiffs have presented their legal arguments on this point and have responded to the Bankers Trust affidavits. That motion is granted. The third claim for relief, the only one directed towards Bankers Trust, is dismissed for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy attempted to be raised therein.

It appears that FNB is an insolvent, whose interests in this case have passed to FDIC and/or EA, and it thus seems appropriate to terminate this litigation in this Court by dismissing the claims as to FNB as well.

Complaint dismissed in its entirety.

So Ordered.

September 30, 1975

Milton Pollack
U.S. District Judge

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

UNITED STATES DISTRICT COURT
Southern District of New York

75 Civ. 909 (MP)

Memorandum

Samue Mallis and Franklyn Kupferman,

Plaintiffs,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants.

Appearances:

Hauser & Rosenbaum
Attorneys for Plaintiffs
350 Fifth Avenue
New York, N.Y. 10001
By: Noel W. Hauser, Esq.

Hughes Hubbard & Reed
Attorneys for Defendant (Federal Deposit Insurance Corporation as Receiver of Franklin National Bank)
One Wall Street
New York, N.Y.
By: Robert S. Anderson, Esq.

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

SULLIVAN & CROMWELL
Attorneys for Defendant (European-American Bank & Trust Company)
48 Wall Street
New York, N.Y.
By: John L. Warden, Esq.

CHARLES LEEDS, Esq.
Attorney for Defendant (Bankers Trust Company)
1775 Broadway, New York, N.Y. 10019
By: Nathan Silverman, Esq.

MILTON POLLACK, District Judge

Since the filing of the decision in this case, defendant Federal Deposit Insurance Corporation has called the Court's attention to 12 U.S.C. § 1819 (1970), which authorizes suit against this defendant in the federal courts on a state law claim.

Accordingly, the dismissal of Count 2 against this defendant is set aside and liability or any other matter pertaining to that claim alone may be reargued. Counsel should submit briefs accordingly within 10 days hereof.

SO ORDERED.

October 2, 1975

MILTON POLLACK
U.S. District Judge

Decision—Opinion of New York Supreme Court.

OPINION OF NADEL, J.

SUPREME COURT : NEW YORK COUNTY
INDIVIDUAL CALENDAR PART 8

Index No. 25831/72

SAMUEL MALLIS,

Plaintiff,

—against—

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR., EQUITY NATIONAL INDUSTRIES INC., EQUITY-TAKE TWO, INC., THE NATIONAL BANK OF GEORGIA, BANKERS TRUST COMPANY and WILLIAM LONDON,

Defendants.

NADEL, J.:

The three separate motions for dismissal of the complaint brought at various times by defendants, Equity National Industries, Bankers Trust Company and William London are consolidated for the purpose of this disposition.

Plaintiff, a dentist, entered into an arrangement with his own lawyer, defendant Arnold, whereby he advanced the sum of $156,728 for one month, and was to receive a "profit" of $50,000.00. As collateral for this loan, plaintiff was to hold 40,384 shares of Equity National Industries, Inc. There is absolutely nothing in the letter from defendant Arnold and defendant Fowler, whose status in this transaction is otherwise undefined, to indicate from whom the Equity shares would be obtained. Plaintiff received $50,000.00. He did not even attend the closing where his funds were transmitted by an officer of Franklin National Bank.

The Equity shares were restricted. The two stock certificates bore a legend to that effect on their face, and on the reverse side spelled out an Escrow Agreement held by the National Bank of Georgia. Arnold asked for and received an affidavit from defendant Kates to the effect that the restrictive legend had no force and effect. The shares were held by defendant Bankers Trust Company as collateral for a loan it had made to defendant Kates. The closing took place at Bankers Trust. Plaintiff thereafter found the stock to be without value and brought this action in conspiracy and fraud against all parties having any connection whatever with the shares or the transaction.

Defendant London, who was Kates' counsel, drafted an agreement between Kates and Arnold, and had no knowledge as to the existence of plaintiff. Moreover, he did not attend the closing. Plaintiff alleges he was guilty of silence when he had a duty to speak, which amounted to a "fraudulent concealment" because he knew of the Escrow Agreement and did not inform plaintiff.

Bankers Trust is likewise charged with the same duty to speak for the protection of plaintiff Equity National Industries, Inc., and is charged with both fraud and negligence in permitting "escrowed stock" into the possession of defendant Kates, thereby allegedly aiding and abetting in the swindle.

Plaintiff is proceeding under several fallacies with respect to facts. The Escrow Agreement sets up two classes of shares, conditional shares which were issued to the stockholders of the company being acquired subject to recall if certain profits were not realized, and final shares, which were held by the escrow agent until the number of final shares to be exchanged for conditional shares could be determined. The conditional shares had a restrictive legend placed on both face and back of each certificate. The restriction did not per se make the stock "worthless"

as plaintiff contends. Equity National did not allow "escrowed shares" to circulate. These were final shares under the terms of the Escrow Agreement, which plaintiff could have determined from the National Bank of Georgia, the escrow agent, as well as transfer agent, if he had taken the precaution of examining the stock certificates.

The leading case on where there is a duty to speak is *Amend* v. *Hurley,* 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this "investment", the Equity shares are called "collateral" and he is guaranteed *repayment* out of another stock transaction.

The "fraudulent concealment" he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend.

The motions to dismiss by these three defendants are granted. Settle orders.

s/ J. NADEL
J.S.C.

Dated: July 13, 1972

Supreme Court, U. S.
FILED
AUG 18 1977
MICHAEL RODAK, JR., CLERK

APPENDIX

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1359

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 4, 1977
CERTIORARI GRANTED MAY 23, 1977

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

POLLACK, J.

PLAINTIFFS

MALLIS, SAMUEL
KUPFERMAN, FRANKLYN

DEFENDANTS

FEDERAL DEPOSIT INSURANCE CORPORATION
EUROPEAN AMERICAN BANK & TRUST COMPANY
FRANKLYN NATIONAL BANK
BANKERS TRUST COMPANY

CAUSE

Viol. of Securities Act of 1933.

ATTORNEYS

DATE	PROCEEDINGS
2-24-75	Filed complaint and issued summons.
2-26-75	Filed Order to Show Cause for preliminary Injunction & Temporary Restraining Order.
4-11-75	Filed deft's ANSWER.
4-14-75	Filed Stip & Order extending time of defts Franklin National Bank & Federal Deposit Insurance Corp to answer complaint to 4/18/75. Pollack, J.
4-17-75	Filed Stip & Order adjourning motion of deft. European American Bank & Trust Co. for an order of dismissal of count 1 & for summary

Relevant Docket Entries.

Date	Proceedings
	judgment as to count II of Complaint to 4/18/75.
4-23-75	Filed Stip. & Order that the time for defts. Franklin National Bank and Federal Deposit Insurance Corp. as Receiver of Franklin National Bank to answer the complaint is ext. to 4-25-75. Pollack, J.
4-25-75	Pretrial before Pollack, J.
5-06-75	Filed Pltffs Notice to take deposition of John Murfitt. Issued Subpoena.
9-25-75	Pretrial before Pollack, J.
9-30-75	(recd this date) Filed Deft. Federal Deposit Insurance Corporation Notice of Motion. re: order dismissing Count 1 of complaint ret. 8/25/75. (recd this date) Filed Deft. Bankers Trust Company re: order dismissing Count III of complaint upon grounds pleading fails to state a claim ret. 8/25/75.
9-30-75	(recd this date) Filed Affdvt by Samuel Mallis & Franklyn Kupferman for pltff in opposition to motion of Deft. European American Bank & Trust Company for dismissal of complaint.
9-30-75	Filed Affdvt of Nathan Silverman for Deft. Bankers Trust Company in answer to Pltff's Memorandum of Law.
9-30-75	Filed Affdvt of Nathan Silverman for Deft. Bankers Trust Company re: furnish pltffs' atty with factual information in order to enable him to respond to same on or before 5/5/75.

Relevant Docket Entries.

Date	Proceedings
9-30-75	Filed Opinion #43153. It appears that FNB is an insolvent, whose interests have passed to FDIC and/or EA, and thus seems appropriate to terminate this litigation in this Court by dismissing claims as to FNB as well. Complaint dismissed in its entirety. So Ordered. Pollack, J. (mn)
10-02-75	Filed Opinion #43187. Since filing of decision in this case, deft. Federal Deposit Insurance Corporation has called Court's attention to 12 USC, Sec. 1819 (1970) which authorizes suit against this deft in federal courts on state law claim. Accordingly, dismissal of Count against this deft is set aside and liability or any other matter pertaining to that claim alone may be reargued. Counsel should submit briefs accordingly within 10 days hereof. So Ordered. Pollack, J.)mn)
10-31-75	Filed pltffs' notice of appeal from order dismissing the complaint as against defts. European-American Bank & Trust Co., Franklin National Bank and The Bankers Trust Co. mailed copies.
11-12-75	Filed letter dated May 6-75 to Judge Pollack with attachment.
11-12-75	Filed Notice that orig. record cert. & transmitted to USCA.
11-25-75	Filed Pltffs Affdvt & Notice of motion re: directing entry of final Judgment as against defts other than Federal Deposit Insurance Corp. so as to permit appeal to Court of Appeals from said dismissals, ret. 12/15/75.

Relevant Docket Entries.

Date	Proceedings
11-28-75	Filed memo End. on motion of 11/25/75. Application for certificate under 28 USC 1292(b) is denied. Motion to enlarge the time as requested to serve, the notice of appeal served, without reference to validity thereof or appeal, ability of the order of 9/30/75. So Ordered, Pollack, J. (mn)
12-15-75	Filed Memo End. on motion of 11/26/75. There is no just reason for leaving a claim against FDIC hanging in limbo and creating piece meal appellate litigation. If there is a viable claim that pltffs intend to pursue against FDIC in matter asserted it should be concluded by trial or other determination so that a complete record is available on all related claims. If pltffs choose not to pursue FDIC albeit it was named in the complaint, the claim may be dismissed for lack of prosecution or withdrawn by pltff but it should be terminated appropriately. Motion denied. Pollack, J. (mn)
12-23-75	Filed true copy of USCA that pltff's notice of appeal is withdrawn. Clk.
03-02-76	Filed Stip & Order that complaint is dismissed with prejudice as against deft. Federal Deposit Insurance Corporation & counterclaim asserted by same as receiver of Franklin National Bank is dismissed with prejudice as against all pltffs, to be without costs in favor of any party against any other. Pollack, J.

Relevant Docket Entries.

Date	Proceedings
03-02-76	Filed Stip & Order that in connection with Stipulation of Dismissal of Complaint as to Federal Deposit Insurance Corporation & of counterclaim filed, pltffs will make no personal claim as against Franklin National Bank, no money judgment as against same, etc. Pollack, J.
03-18-76	Filed Letter dated 11/26/75 from attys for Bankers Trust Co.
03-18-76	Filed Letter dated 10/1/75 from pltff's atty. with atchd deposition.
03-24-76	Filed Pltffs Notice of Appeal from Order and Judgment of Hon. Milton Pollack, dismissing complaint as against defts. European-American Bank & Trust Company, Franklin National Bank and the Bankers Trust Company (copy mailed to Hughes, Hubbard & Reed; Sullivan & Cromwell & Charles Leeds on 3/25/76)
04-12-76	Filed Notice that record on appeal certified & transmitted to USCA.

Complaint.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs,

—against—

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Defendants.

Plaintiffs, complaining of the defendants, by their attorneys, Hauser & Rosenbaum, P.C., respectfully allege:

FIRST COUNT

First: The jurisdiction of this Honorable Court is invoked pursuant to the Securities Act of 1933, §§ 12-17, and the laws of the United States creating the Board of Governors of the Federal Reserve System and empowering them to enact regulations, particularly Regulation U, 12 C.F.R. 221, et seq., and 15 U.S.C. 78 cc.

Second: Upon information and belief, Franklin National Bank (Franklin) was and is a domestic banking corporation. At all times here material, it conducted a banking business and was subject to the Securities Act of 1933 and the aforesaid Regulation U, 12 C.F.R. 221, et seq.

Third: Upon information and belief, Bankers Trust Company (Bankers) was and is a domestic banking corporation. At all times here material, it conducted a banking business and was subject to the Securities Act of 1933 and the aforesaid Regulation U, 12 C.F.R. 221, et seq.

Fourth: Upon information and belief, European American Bank & Trust Company (European) was and is a domestic banking corporation. At all times here material, it conducted a banking business and was subject to the Securities Act of 1933 and the aforesaid Regulation U, 12 C.F.R. 221, et seq.

Fifth: Upon information and belief, the defendant Federal Deposit Insurance Corporation (Federal) was and is a corporation duly organized and existing under the laws and statutes of the United States, and was and is acting as Receiver and Liquidator of the defendant, Franklin, and it is named as a defendant in such capacity.

Sixth: Upon information and belief, defendants European and Federal are successors in interest to the defendant Franklin, and either or both defendants have assumed all rights and obligations of the said Franklin.

Seventh: On or about March 2, 1972, Franklin advanced to or for the account of one Jerome Kates and one Judith Kates $156,748.00, receiving in return certain documents purporting to represent 40,384 shares of the common stock of Equity National Industries, Inc.

Eighth: The said common stock certificates of Equity National Industries, Inc. and the interests represented thereby, were not registered as required by the Securities Act of 1933, and the transfer thereof violated the aforesaid Act of 1933.

Ninth: The advancement of funds by Franklin to or for the account of Jerome Kates and Judith Kates was pur-

portedly for the account of the plaintiff Mallis in the sum of approximately $78,000.00, and purportedly for the account of plaintiff Kupferman in the sum of approximately $78,000.00, and was purportedly intended by Franklin as a loan to each of the plaintiffs in the sums stated to enable plaintiffs to lend or advance the said sums to or for Jerome and Judith Kates. Defendant Franklin knew and understood that there was to be received in return 40,384 shares of the common stock of Equity National Industries, Inc. by way of security for the payment of certain sums of money to plaintiffs and Franklin.

Tenth: Upon information and belief, the aforesaid Regulation U, 12 C.F.R. 221, prohibited the making of a loan or advance to or for the plaintiffs or otherwise, for the purposes intended.

Eleventh: As a condition to the making of the purported loan or advance by the defendant Franklin for the account of plaintiffs, Franklin required the plaintiffs to execute notes in favor of Franklin and further required that the promise of payment of the aforesaid notes be collateralized by each of the plaintiffs with a pledge of their respective bankbooks, securities, etc.

Twelfth: Defendant Franklin, its agents, servants and employees, fraudulently or negligently failed to disclose to the plaintiffs that it was prohibited from loaning or advancing monies for the account of the plaintiffs, or otherwise, for the purposes intended.

Thirteenth: By virtue of transactions between and amongst defendants Franklin, Federal and European, concerning which plaintiffs have no information, defendant European is now the holder of the notes or renewals thereof, executed by plaintiffs in favor of defendant Franklin,

as well as the collateral pledged in connection therewith. Upon information and belief, the defendant Federal has or may have a contingent interest in the aforesaid notes and collateral and the disposition thereof.

Fourteenth: Plaintiffs seek rescission of the aforesaid transaction, as well as declaratory judgment that the said transaction and any notes or other evidences of indebtednesses executed by plaintiffs, or either of them in connection therewith are null and void and are of no force and effect. Plaintiffs furthermore seek an Order and Judgment of the Court directing the return of all collaterals owned by them and possessed by the defendants, or any of them. Plaintiffs furthermore seek a preliminary injunction restraining the defendants from further transferring by any manner or means whatever, the aforesaid notes or other evidences of indebtednesses and the property of the plaintiffs purportedly held by the defendants as collateral in connection therewith.

Fifteenth: Plaintiffs have no adequate remedy at law.

COUNT II

Sixteenth: Preliminary to the payment by defendant Franklin to or for the account of Jerome and Judith Kates, purportedly for and in behalf of plaintiffs, Franklin, its agents, servants and employees, represented to the plaintiffs that Franklin investigated to determine the reputation of the said Jerome Kates and Judith Kates and the genuineness and value of the common stock of Equity National Industries, Inc., which were to be received in conjunction with the proposed transaction. Franklin, its agents, servants and employees, represented and reported to the plaintiffs that the said Jerome Kates and Judith Kates enjoyed a good reputation in the business com-

munity, that the 40,384 shares of the common stock of Equity National Industries, Inc. to be received were genuine, marketable, free of restrictions, and having a value convertible to cash in thirty days in an amount far in excess of $156,000.00.

Seventeenth: The plaintiffs relied on each of the foregoing representations in agreeing to have the defendant Franklin advance funds for the purposes described.

Eighteenth: The aforesaid statements and representations made by Franklin, its agents, servants and employees, were false and were either fraudulently or negligently uttered. The 40,384 shares of the common stock of Equity National Industries, Inc. represented by Certificates #s U-1828 and U-1833 to be received, reflected on their face that they were not registered as required by the Securities Act of 1933 and that they were subject to the provisions of a certain agreement which prohibited the transfer, pledge or hypothecation of the aforesaid securities, all of which was well known to the defendant Franklin.

Nineteenth: The aforesaid stock certificates were received by the defendant Franklin, its agents, servants and employees, contemporaneously with the payment by the defendant Franklin of the sum of $156,784.00, purportedly for the account of the plaintiffs at a closing attended by an officer of Franklin in behalf of the plaintiffs who did not attend in reliance upon the assurances theretofore received by them from the defendant Franklin, its agents, servants and employees.

COUNT III

Twentieth: Prior to March 2, 1972, defendant Bankers held as collateral for monies loaned to one, Jerome Kates

and one, Judith Kates, Certificates #s U-1828 and U-1833 of Equity National Industries, Inc., representing 40,384 shares of the common stock of the issuer.

Twenty-First: Upon information and belief, defendant Bankers was prohibited by the Securities Act of 1933 from receiving the aforesaid stock certificates and the interests thereby represented as collateral securities for a loan to the said Jerome Kates and Judith Kates.

Twenty-Second: Upon information and belief, defendant Bankers was further prohibited by the Securities Act of 1933 from disposing of the aforesaid securities, except to redeliver the same to the said Jerome Kates or Judith Kates, or the issuer.

Twenty-Third: The provisions of the Securities Act of 1933 to the contrary notwithstanding, defendant Bankers transferred the aforesaid securities to plaintiffs, or their nominee, all in violation of the Securities Act of 1933, in return for which Bankers received from Franklin the sum of $45,000.00, purportedly paid by Franklin to Bankers as part of the proceeds of a loan by Franklin to plaintiffs.

Twenty-Fourth: The acts and conduct of the defendant Bankers, did upon information and belief, violate the Securities Act of 1933.

Twenty-Fifth: That by reason thereof, plaintiffs have been damaged in the sum of $45,000.00.

WHEREFORE, plaintiffs seek a judgment and decree of this Court as follows:

(a) Adjudging, decreeing and declaring that the purported loans and advances made by Franklin allegedly for and in behalf of the plaintiffs were illegal and improper

and plaintiffs are not liable for the payment of any sums whatever to Franklin or its successors in interest, European and Federal.

(b) Directing that all sums paid by plaintiffs to Franklin, and its successors in interest, including payments on account of principal and payments on account of interest should be returned to plaintiffs.

(c) Enjoining during the pendency of this action and permanently the further transfer of any notes or other evidences of debt executed by the plaintiffs, and either of them, in favor of Franklin, or any successor in interest, and arising out of the transactions described in this Complaint.

(d) Directing the return of all collaterals delivered by the plaintiffs to Franklin, and to any successor in interest, to Franklin.

(e) Directing the delivery to the Court for destruction of all evidences of debt executed by the plaintiffs in favor of Franklin and any successor in interest thereof, arising from the transactions described in this Complaint.

(f) A money judgment against Bankers in the sum of $45,000.00.

(g) The costs and disbursements of this action.

Dated: Brooklyn, New York
February 21, 1975

HAUSER & ROSENBAUM, P.C.

By .....
A Member of the Firm
Attorneys for Plaintiffs

Order to Show Cause.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

It appearing from the Summons and Complaint and the affidavit of plaintiffs, Samuel Mallis and Franklyn Kupferman, sworn to February 21, 1975 and of Noel Hauser, sworn to February 24, 1975 that an action has been commenced by plaintiffs to rescind and declare void a certain loan transaction between them and the defendant, Franklin National Bank; and it further appearing that in the event such relief is granted plaintiffs will be entitled to the return of negotiable instruments and other evidences of debt executed by them; and it further appearing that the negotiation of negotiable instruments executed by plaintiffs may prejudice the rights of the plaintiffs and frustrate the policy of Federal Law, it is

ORDERED, that the defendants be and they are hereby directed to show cause before this Court at a Term for Motions thereof to be held in Room 906, on the 25 day of February, 1975, at 3 P.M. o'clock in the forenoon thereof, at the United States Courthouse, Foley Square, New York, New York,

WHY, an order should not be made and entered herein granting plaintiffs a preliminary injunction restraining the defendants from the negotiation or other transferral of negotiable instruments executed by the plaintiffs in favor of Franklin National Bank on March 3, 1972 and why an injunction should not be granted further restraining the

Order to Show Cause.

negotiation of any notes executed by plaintiffs by way of renewal of such notes.

It is further ordered that personal service of this order to show cause & papers therein be made on defendants or their attorneys by 4 P.M. on 2/24/75.

MILTON POLLACK
United States District Judge
USDJ

Dated: New York, N.Y.
2/24/75
Issued at 1:30 P.M.

Affidavit of Samuel Mallis and Franklyn Kupferman, in Support of Order to Show Cause.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK }
COUNTY OF KINGS } ss.:

SAMUEL MALLIS and FRANKLYN KUPFERMAN, both being duly sworn, do depose and say:

1. That they are the plaintiffs in the instant action and that they make this affidavit in support of an application for an Order granting a temporary injunction restraining the enforcement and transfer by negotiation or otherwise, by the defendants Franklin National Bank (Franklin), Federal Deposit Insurance Corporation (Federal) and European American and Trust Company (European) of said notes or evidences of indebtednesses executed by the plaintiffs in favor of Franklin and/or European during the pendency of this action; and further enjoining them from disposing of certain collateral owned by plaintiffs and possessed by the said defendants, or some of them. The instant action is brought for rescission of a certain loan made by Franklin to plaintiffs and for declaratory judgment that the loan is of no force and effect because made in violation of Regulation U promulgated by the Board of Governors of the Federal Reserve System, as well as for other reasons, more particularly hereinafter described, and described in the Complaint hereto annexed.

2. Plaintiff, Franklyn Kupferman, resides at 15 Belmont Drive South, Roslyn Heights, N.Y. and plaintiff,

Samuel Mallis, resides at 19 Peacock Drive, Roslyn, New York. Both are professional dentists unfamiliar with financial matters and with sophisticated securities, regulations and trading. Defendant, Federal, has its office at 345 Park Avenue, New York, New York; defendant, European, has its office at 10 Hanover Square, New York, New York; defendant, Franklin, has its office at 450 Park Avenue, New York, New York; and defendant, Bankers Trust Company (Bankers) has its office at 16 Wall Street, New York, New York.

3. On March 1, 1972, Plaintiff Samuel Mallis was approached by one Jack J. Arnold, known to plaintiff Mallis as an attorney in the City of New York. Arnold represented to Mallis that he or one John Fowler, an officer of Love & Company, a securities broker, had entered into an agreement with one Jerome Kates and his wife Judith Kates to purchase 40,384 shares of unregistered securities issued by Equity National Industries, Inc. for a price of approximately $181,000.00; that Arnold and Fowler or Love & Company had already advanced $25,000.00 toward the purchase of these securities; that an additional sum of approximately $156,000.00 was required within several days thereafter to consummate the purchase; that while the securities were unregistered, the Securities Exchange Commission had theretofore recently promulgated a Regulation which permitted the trading of these securities as if registered; and that the value of the approximately 40,000 shares of Equity National Industries, Inc. (Equity) when traded at the then market price was several times the purchase price of $181,000.00 Arnold advised Mallis that he and Fowler or Love & Company were offering a finder's fee of $50,000.00 to a finder who could produce a lender willing to advance $156,000.00 for thirty days, the loan to be collateralized by the aforesaid 40,000 shares of Equity.

4. Plaintiff Mallis did not have funds of this magnitude and in any event, was not interested in lending money for any purpose; additionally, plaintiff Mallis was not interested in any finder's fee and so advised Arnold; however, he assured Arnold that he would make inquiries among his personal friends, relatives and associates in an attempt to locate a lender willing to participate in this transaction. Accordingly, plaintiff communicated with, amongst others, his brother-in-law, the plaintiff Kupferman, who in turn referred plaintiff Mallis to one John Murfitt, an officer of Franklin. Murfitt was advised, as Mallis had been advised, that time was of the essence. Mallis further advised Murfitt that he had no interest whatever in participating in the transaction or in earning a finder's fee.

5. On March 2, 1972, Murfitt communicated with plaintiffs. He stated that he had investigated the transaction in detail; that the transaction appeared regular in all respects, and as had been represented to Mallis by Arnold. However, Murfitt further represented that Franklin would be unable to advance the funds to Arnold or Fowler or Love & Company because Franklin had no relationship with any of them. He thereupon went on to point out that Franklin would be happy to advance the funds for the account of plaintiffs, since plaintiffs were known to Franklin and to Murfitt, and that in so doing, plaintiffs would receive the finder's fee. This was the first suggestion by anyone that plaintiffs themselves participate in the transaction.

6. Plaintiffs advised Murfitt that they would be absolutely unwilling to act as principals in the transaction, unless they received an absolute assurance from Murfitt and Franklin that they could suffer no loss since they were not in the finance business and had made no investigation whatever regarding the nature of the transaction. Murfitt

thereupon responded that the transaction was one which was absolutely regular and of the character conducted regularly in the ordinary course of business by Franklin and he, in fact, recommended that plaintiffs become the borrowers so as to facilitate Franklin's advancement of the funds as required by Arnold, Fowler and Love & Company. The understanding was that the monies to be advanced by the bank were to be repaid within thirty days and that the Equity securities would be held as collateral for the loan and the finder's fee during that period.

7. Plaintiffs were unaware until very recently that Regulation U prohibited the bank's loaning of monies for this purpose.

8. On March 3, 1972, plaintiffs attended at Franklin and executed the necessary documents whereby in form they made application to Franklin to each borrow the sum of approximately $78,000.00. The loans were then completely unsecured. Since Murfitt indicated that there was no occasion for them to attend the closing at which time the monies would be paid and the stock certificates received, plaintiffs did not attend the closing, but rather Murfitt, in behalf of Franklin, attended. While plaintiffs do not know the same to be the fact since they were not present, they assume that Franklin actually paid out the sums represented by Franklin to be paid out, to wit, the sum of $156,748.00. In return, there was received Stock Certfiicate #U-1833 and Stock Certificate #U-1828 purporting to represent respectively, 29,821 and 10,563 shares of common stock of Equity National Industries, Inc.

9. The monies were, of course, not repaid as agreed. Franklin, and its successors in interest, European, has taken the position and now takes the position that plaintiffs are liable for the said sum of $156,000.00 less $50,000.00 paid on account plus all interest. In addition, Franklin demanded and received of plaintiffs collateral, which they received of plaintiffs and now hold. Said collateral consists of bankbooks, negotiable securities, etc.

10. Plaintiffs do not have all of the documents relating to the within transaction. However, there are annexed hereto the following documents which support the allegations of the instant affidavit:

EXHIBIT "A": A Purchase Agreement whereby Jerome B. Kates and Judith Kates agree to sell the approximately 40,000 shares of Equity National Industries, Inc. to Jack Arnold (the attention of this Honorable Court is invited to ¶ "4" thereof which obligates Arnold to execute a "Letter of Investment"; however, no such Letter of Investment was requested to be signed by the plaintiffs, or either of them, and no such letter was, in fact, signed.

EXHIBIT "B": Front and reverse sides of Franklin National Bank Official Checks #773582, 773583 and 773584, all signed by the aforesaid John Murfitt in behalf of Franklin aggregating the sum of $156,748.00. The attention of this Honorable Court is invited to the fact that none of the checks was approved for payment by the plaintiffs, or either of them; nor do they bear the endorsement of the plaintiffs.

EXHIBIT "C": Front and reverse sides of Certificates #s U-1828 and U-1833 of the common stock of Equity National Industries, Inc. issued in the names of Jerome Kates and Judith Kates. The attention of this Honorable Court is invited to the fact that the securities bear evidence on their face that they are not registered under the

Securities Act of 1933. The endorsement side of each of the certificates reflect that they are further subject to an Escrow Agreement and that the certificates "may not be sold, transferred, pledged or hypothecated except in accordance with such Escrow Agreement, a copy of which may be examined at the office of the corporation." Upon information and belief, the Escrow Agreement was never examined by John Murfitt or by any representative of Franklin. Since plaintiffs were not present at the closing, they never saw the certificates and more particularly, the caveat prohibiting their sale until after the funds had actually been disbursed. Upon information and belief, the certificates in question were only conditionally issued by Equity National Industries, Inc. and were to be deemed null and void and were subject to cancellation in the event certain conditions set forth in the agreement therein referred to were not met. Upon information and belief, these conditions were, in fact, not met, and the certificates in question are indeed null and void and have been cancelled as more particularly hereinafter appears.

Exhibit "D": A copy of a Summons and Complaint issued out of the Chancery Court of the State of Delaware by Equity National Industries, Inc. as plaintiff, naming both Samuel Mallis, a plaintiff herein, and the said defendant, Franklin National Bank, amongst others, wherein it is alleged, *inter alia,* that the securities in question were issued conditionally only (the conditions presumably being spelled out in the agreement to which reference is made on the endorsement side of the stock certificates (Exhibit "C"); that the conditions had not been met and that the securities in question should be declared null and void by the Chancery Court of the State of Delaware. Upon information and belief, such an adjudication has, in fact, been entered.

11. Plaintiffs are informed by their attorneys and believe that the conduct of Franklin, its agents, servants and employees, in advancing the funds for the purposes described not only violated the Securities Act of 1933 and Regulation U of the regulations promulgated by the Board of Governors of the Federal Reserve System, but that, additionally, it was in the circumstances the absolute duty and responsibility of Franklin to prevent the plaintiffs from being misled by the acceptance of securities which were only conditionally issued and subject to an agreement which had not been examined.

12. Plaintiffs understand and believe that defendant Franklin is insolvent, but that all of its assets and all of its liabilities have been assumed by the defendant, European, subject to an arangement with the defendant Federal that European may reject certain of the transactions of Franklin giving rise to rights and obligations; and that in such event, the rights and obligations arising therefrom would be assumed by Federal.

13. Plaintiffs believe that they executed negotiable instruments in favor of Franklin and that in the event these instruments are transferred or negotiated to third parties, it is possible that the claims herein asserted may be foreclosed. Under the circumstances, it is respectfully requested that this Honorable Court issue an injunction restraining the negotiation or transfer of any and all negotiable papers and other evidences of indebtedness executed by the plaintiffs, and either or both of them, in favor of the defendants Franklin, European and Federal, and that the injunction further prohibit the transfer or equitable conversion of any of the collateral held by the aforesaid defendants, pending determination of the issues herein presented.

Affidavit of Samuel Mallis and Franklyn Kupferman.

14. No previous application for the relief requested herein has been made.

WHEREFORE, plaintiffs respectfully pray that the annexed proposed Order be signed.

SAMUEL MALLIS
Samuel Mallis

FRANKLIN KUPFERMAN
Franklin Kupferman

Sworn to before me this
21 day of February, 1975.

NOEL HAUSER
Notary Public, State of New York
No. 30-1710850. Qual. in Nassau County
Commission Expires March 30, 1975

Exhibit A Annexed to Affidavit of Mallis and Kupferman.

PURCHASE AGREEMENT

THIS AGREEMENT, made and entered into at New York, New York this 24th day of February, 1972, by and between JEROME B. KATES and JUDITH KATES by Jerome B. Kates, as attorney (hereinafter jointly referred to as the "Seller"), and JACK ARNOLD as attorney (hereinafter referred to as the "Buyer").

WITNESSETH

WHEREAS, Seller is hereby assigning all of its right, title and interest in and to 40,384 shares of duly issued and outstanding shares of the capital stock of Equity National Industries, Inc., a Delaware corporation, and

WHEREAS, the Buyer agrees to pay to the Seller the price of $4.50 per share or the aggregate sum of $181,728.00 by good bank check simultaneously against delivery of stock certificate number 1833 for 29,821 shares of Equity National Industries, Inc. in the name of Jerome B. Kates and certificate number 1828 for 10,563 shares of Equity National Industries, Inc. in the name of Judith Kates, which certificates are presently held by Bankers Trust Co. at 750 Third Avenue, New York, N.Y. and the net sum that the Seller will receive pursuant to this private sale is $181,728.00 to be paid by the Buyer, and Seller acknowledges receipt of $25,000.00 as a partial payment against the price of $181,728.00.

WHEREAS, Seller desires to sell to Buyer, and Buyer desires to purchase from Seller, the number of shares of Equity National Industries, Inc. as hereinabove set forth, on the terms and conditions hereinafter set forth.

Exhibit A Annexed to Affidavit of Mallis and Kupferman.

Now Therefore, in consideration of the mutual promises and agreements hereinafter contained, the parties hereby agree as follows:

1. The Seller unconditionally represents and warrants to make good and valid delivery of the aforementioned certificates of common stock to Buyer as hereinabove set forth.

2. Seller represents and warrants that the aforementioned stock certificates are validly issued, duly authorized and outstanding on the books of Equity National Industries, Inc.

3. Each of the Sellers is the owner of record and beneficially of the number of shares of the common stock of the Company as indicated below:

Name	*Number of Shares Held*
Jerome B. Kates	29,821
Judith Kates	10,563

4. Buyer agrees to execute an "investment letter", in a form mutually satisfactory to the parties herein which will protect the Seller from any Securities and Exchange Commission rules and regulations.

5. Buyer and its successors and assigns will indemnify Seller and hold Seller harmless, at all times after the Closing Date, and defend at its sole cost and expense against any and all loss, damage, liability, claim or suit presently pending or in the future arising out of this transaction.

Exhibit A Annexed to Affidavit of Mallis and Kupferman.

6. Any and all agreements previously entered into between Seller and any other parties relating to this transaction are declared null and void and this agreement is to survive any and all agreements previously entered into.

7. The closing of this transaction shall take place no later than 2:00 P.M. on February 29, 1972, time being of the essence of this transaction.

In Witness Whereof the parties hereto have duly executed their signatures.

Jerome B. Kates
Jerome B. Kates

Judith Kates
By Jerome B. Kates, Attny.
Jerome B. Kates, Attny.

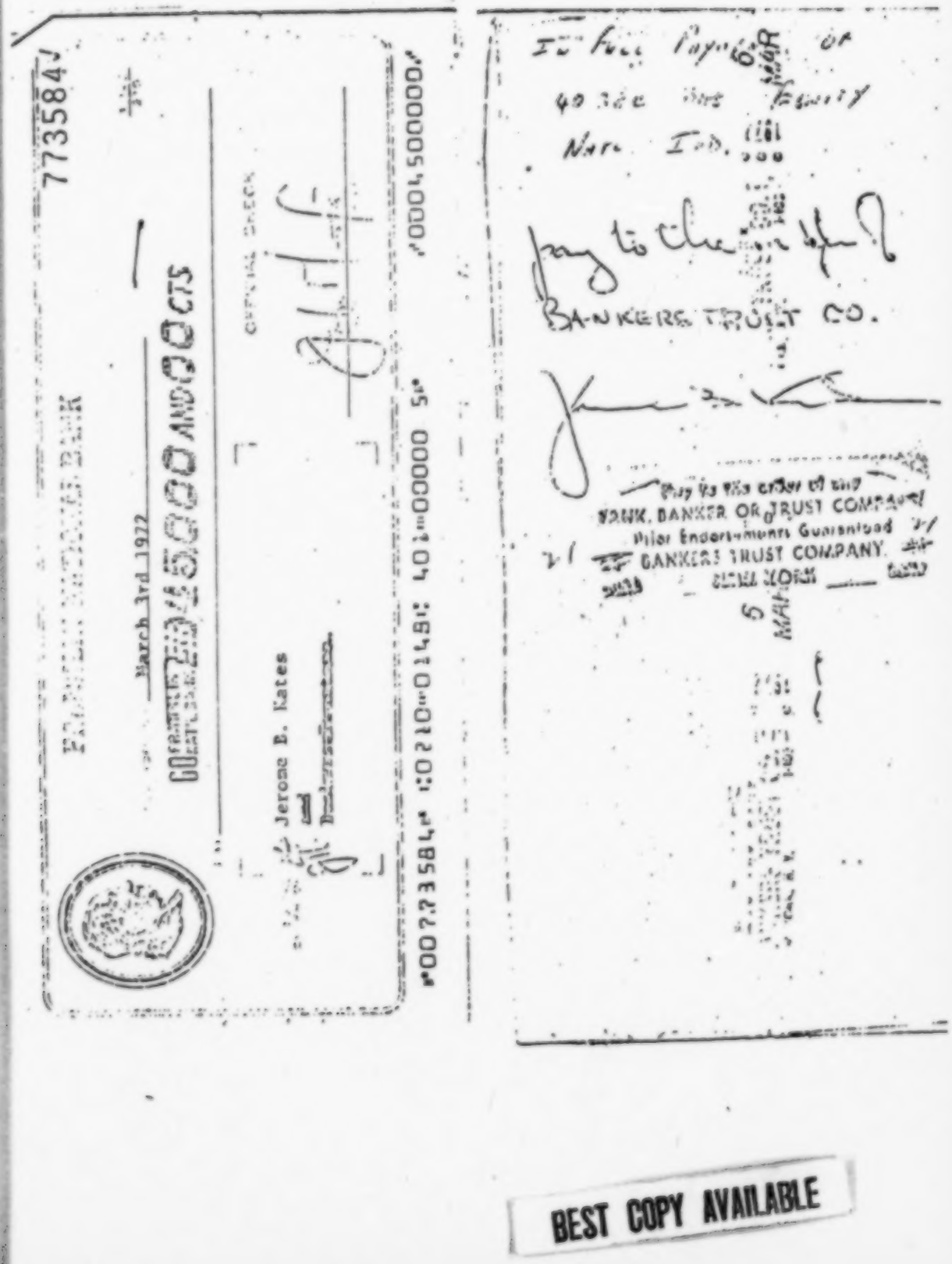
Jack Arnold as Attorney

Exhibit B Annexed to Affidavit of Mallis and Kupferman.

Franklin National Bank official checks #773582, 773583, 773584.

(Photoprint)

[For convenience of Court and Counsel this Exhibit is bound in on the opposite page]



BEST COPY AVAILABLE

Exhibit B Annexed to Affidavit of Mallis and Kupferman.

(continued)

(Photoprint)

[*For convenience of Court and Counsel this Exhibit is bound in on the opposite page*]

BEST COPY AVAILABLE

Exhibit B Annexed to Affidavit of Mallis and Kupferman.
(continued)

(Photoprint)

[For convenience of Court and Counsel this Exhibit is bound in on the opposite page]

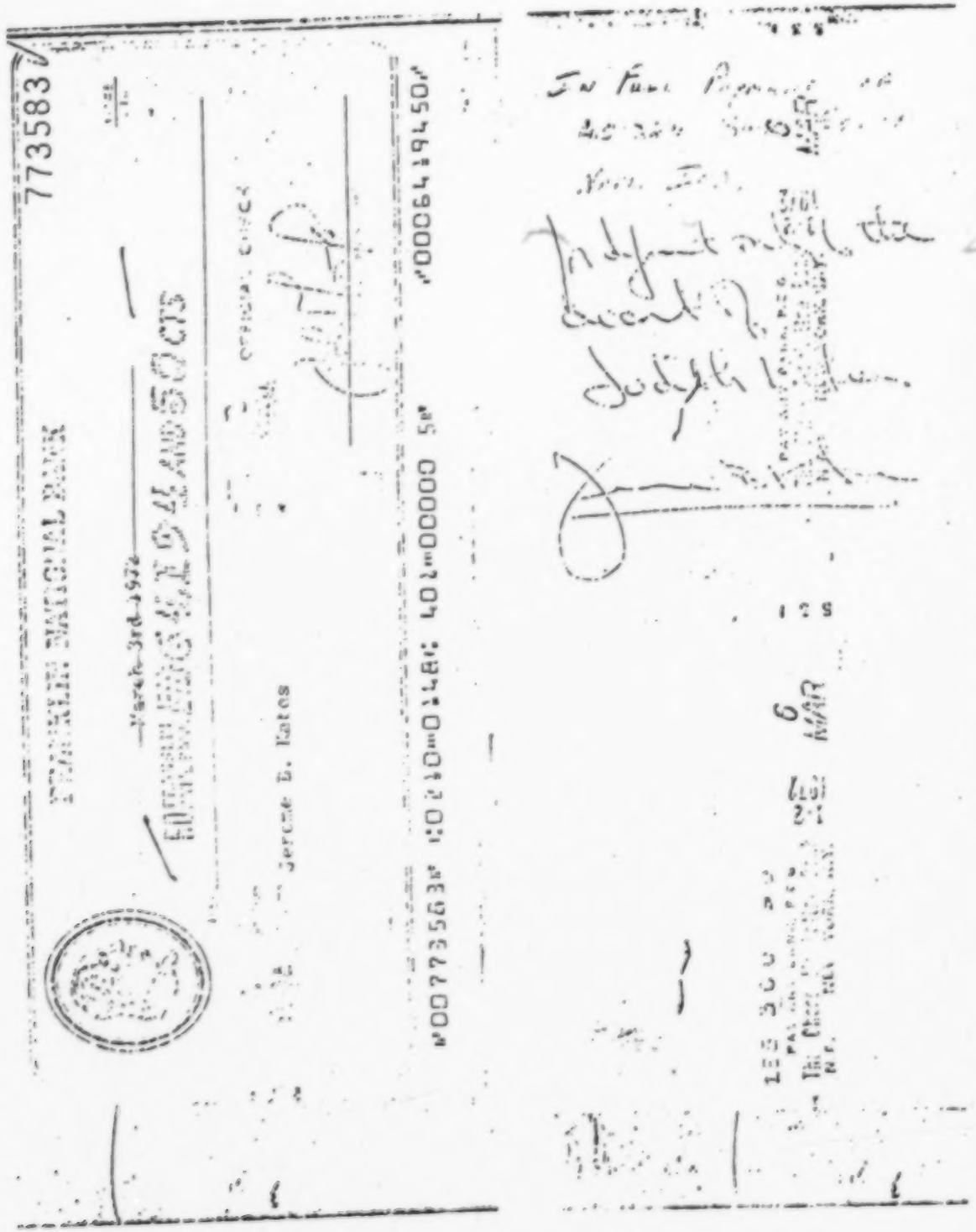
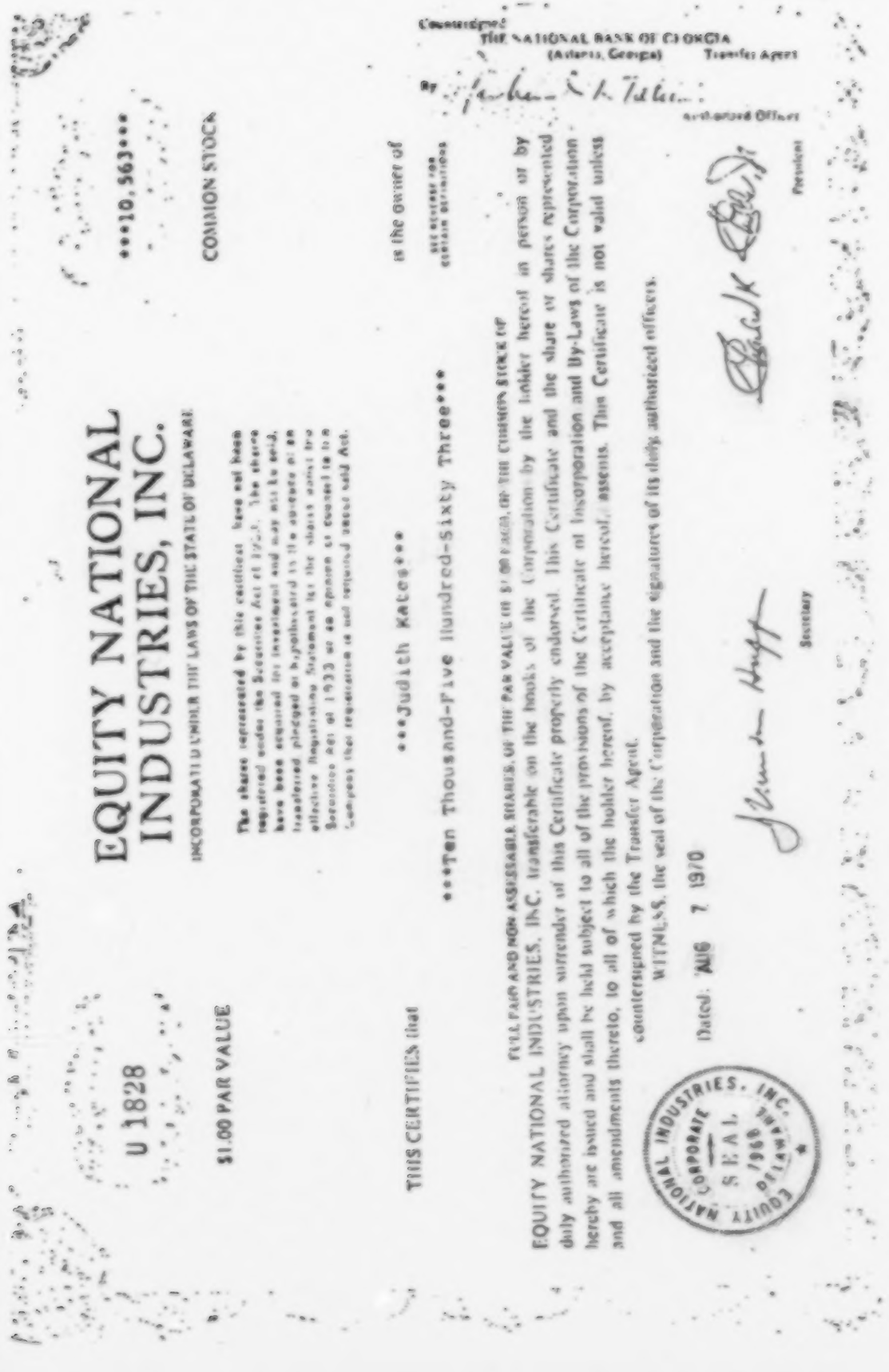


Exhibit C Annexed to Affidavit of Mallis and Kupferman.

Certificates #U-1828 and #U-1833 of the Common Stock of Equity National Industries, Inc.

(Photoprint)

[For convenience of Court and Counsel this Exhibit is bound in on the opposite page]


EQUITY NATIONAL INDUSTRIES, INC.

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE

U 1828

$1.00 PAR VALUE

10,563

COMMON STOCK

Countersigned:
THE NATIONAL BANK OF GEORGIA
(Atlanta, Georgia) Transfer Agent
By
Authorized Officer

The shares represented by this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and may not be sold, transferred, pledged or hypothecated in the absence of an effective Registration Statement for the shares under the Securities Act of 1933 or an opinion of counsel to the Company that registration is not required under said Act.

Judith Kates

THIS CERTIFIES that

Ten Thousand-Five Hundred-Sixty Three

is the owner of

FULL PAID AND NON ASSESSABLE SHARES OF THE PAR VALUE OF

EQUITY NATIONAL INDUSTRIES, INC. transferable on the books of the Corporation by the holder hereof in person or by duly authorized attorney upon surrender of this Certificate properly endorsed. This Certificate and the share or shares represented hereby are issued and shall be held subject to all of the provisions of the Certificate of Incorporation and By-Laws of the Corporation and all amendments thereto, to all of which the holder hereof, by acceptance hereof, assents. This Certificate is not valid unless countersigned by the Transfer Agent.

WITNESS, the seal of the Corporation and the signatures of its duly authorized officers.

Dated: AUG 7 1970

EQUITY NATIONAL INDUSTRIES, INC. CORPORATE SEAL 1968 DELAWARE

Secretary

President

Exhibit C Annexed to Affidavit of Mallis and Kupferman.

(continued)

(Photoprint)

[*For convenience of Court and Counsel this Exhibit is bound in on the opposite page*]

The shares evidenced by this certificate are subject to the provisions of an Escrow Agreement dated August 7, 1970 among the Corporation, Equity-Take Two, Inc., The National Bank of Georgia and Stanley C. Lesser, as nominee for the former shareholders of Take Two, Inc., and may not be sold, transferred, pledged or hypothecated except in accordance with such Escrow Agreement, a copy of which may be examined at the office of the Corporation.

/

Dated, ...

Attorney to transfer the said stock on the books of the within-named Corporation with full power of substitution in the premises.

NOTICE: The signature to this assignment must correspond with the name as written upon the face of the Certificate, in every particular, without alteration or enlargement, or any change whatever.

For value received, ... hereby sell, assign and transfer unto

Please insert social security or other identifying number of assignee

Please print or typewrite name and address including postal zip code of assignee

..... Shares

of the capital stock represented by the within Certificate, and do hereby irrevocably constitute and appoint.....

The following abbreviations, when used in the inscription on the face of this certificate, shall be construed as though they were written out in full according to applicable laws or regulations:

TEN COM — as tenants in common
TEN ENT — as tenants by the entirety
JT TEN — as joint tenants with right of survivorship and not as tenants in common

UNIF GIFT MIN ACT — ..... Custodian ..... (Cust.) (Minor) under Uniform Gifts to Minors Act ..... (State)

Additional abbreviations may also be used though not in the above list.

EQUITY NATIONAL INDUSTRIES, INC.

THE CORPORATION WILL FURNISH WITHOUT CHARGE TO EACH STOCKHOLDER WHO SO REQUESTS, THE DESIGNATIONS, PREFERENCES AND RELATIVE, PARTICIPATING, OPTIONAL OR OTHER SPECIAL RIGHTS OF EACH CLASS OF STOCK OR SERIES THEREOF OF THE CORPORATION, AND THE QUALIFICATIONS, LIMITATIONS OR RESTRICTIONS OF SUCH PREFERENCES AND/OR RIGHTS. SUCH REQUESTS MAY BE MADE TO THE CORPORATION OR THE TRANSFER AGENT.

BEST COPY AVAILABLE

Exhibit C Annexed to Affidavit of Mallis and Kupferman.
(continued)

(Photoprint)

[*For convenience of Court and Counsel this Exhibit is bound in on the opposite page*]

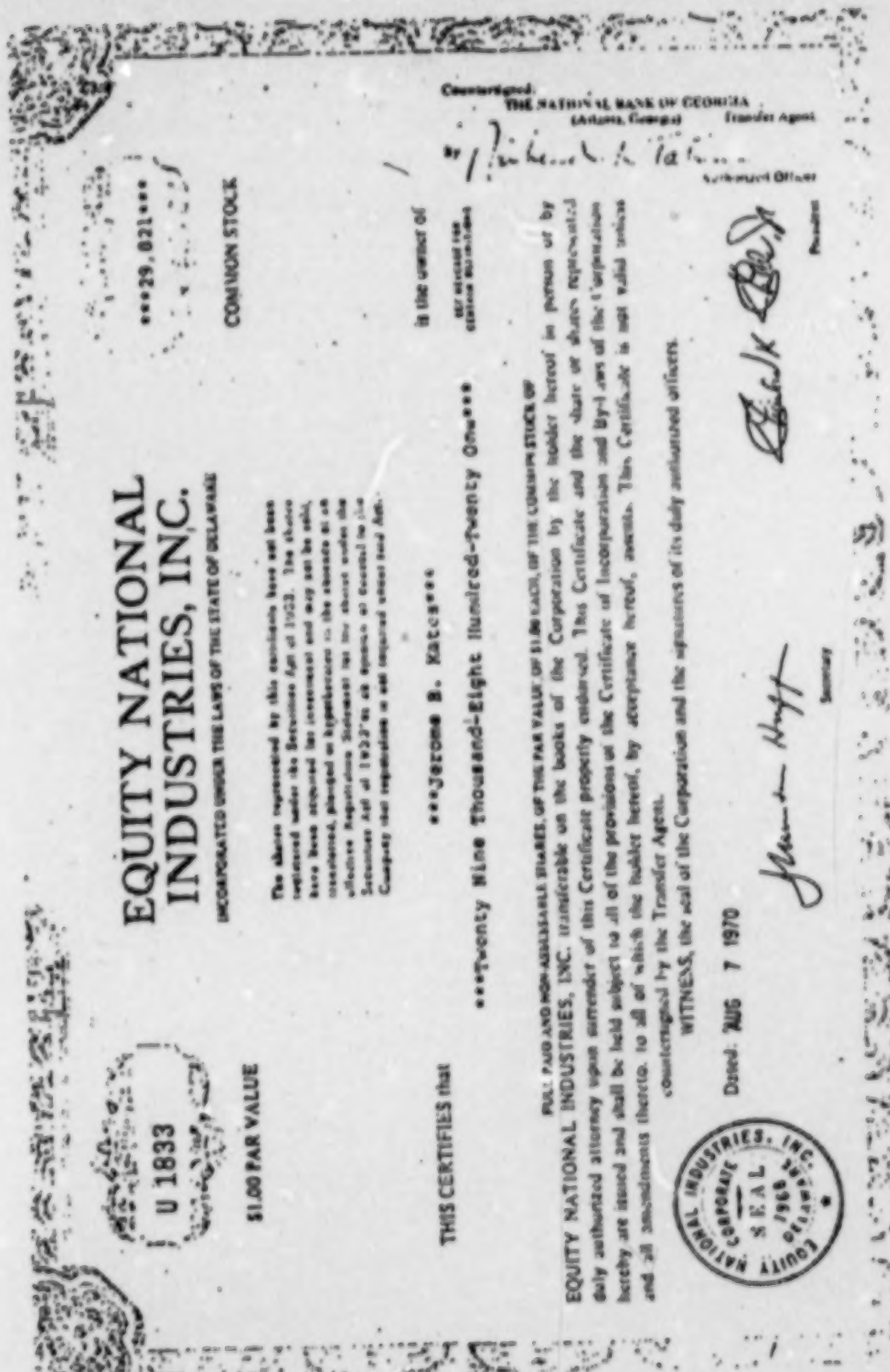


Exhibit C Annexed to Affidavit of Mallis and Kupferman.

(continued)

(Photoprint)

[*For convenience of Court and Counsel this Exhibit is bound in on the opposite page*]

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EQUITY NATIONAL INDUSTRIES, INC.

THE CORPORATION WILL FURNISH WITHOUT CHARGE TO EACH STOCKHOLDER WHO SO REQUESTS, THE DESIGNATIONS, PREFERENCES AND RELATIVE, PARTICIPATING, OPTIONAL OR OTHER SPECIAL RIGHTS OF EACH CLASS OF STOCK OR SERIES THEREOF OF THE CORPORATION, AND THE QUALIFICATIONS, LIMITATIONS OR RESTRICTIONS OF SUCH PREFERENCES AND/OR RIGHTS. SUCH REQUESTS MAY BE MADE TO THE CORPORATION OR THE TRANSFER AGENT.

The following abbreviations, when used in the inscription on the face of this certificate, shall be construed as though they were written out in full according to applicable laws or regulations:

TEN COM	— as tenants in common	UNIF GIFT MIN ACT —	(Cust.) (Minor) under Uniform Gifts to Minors Act (State)
TEN ENT	— as tenants by the entirety		
JT TEN	— as joint tenants with right of survivorship and not as tenants in common		

Additional abbreviations may also be used though not in the above list.

For value received, ... hereby sell, assign and transfer unto

PLEASE INSERT SOCIAL SECURITY OR OTHER IDENTIFYING NUMBER OF ASSIGNEE

Please print or typewrite name and address including postal zip code of assignee

.....

.....

.....

.....

Shares of the capital stock represented by the within Certificate, and do hereby irrevocably constitute and appoint .....

Attorney to transfer the said stock on the books of the within-named Corporation with full power of substitution in the premises.

Dated, ...

NOTICE: The signature to the assignment must correspond with the name as written upon the face of the Certificate, in every particular, without alteration or enlargement, or any change whatever.

Exhibit D Annexed to Affidavit of Mallis and Kupferman.

Summons and Complaint issued out of the Chancery Court of the State of Delaware by Equity National Industries, Inc.

SUMMONS.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

Civil Action No. 4510

EQUITY NATIONAL INDUSTRIES, INC., a corporation of the State of Delaware,

Plaintiff,

v.

JEROME B. KATES, JUDITH KATES, MURRAY BERLINER, VITO DOINO, LILLIAN COLLICA, SAMUEL MALLIS, JACK J. ARNOLD, and FRANKLIN NATIONAL BANK, a corporation of the State of New York,

Defendants.

THE STATE OF DELAWARE,

TO THE SHERIFF OF NEW CASTLE COUNTY:

YOU ARE COMMANDED:

To Summon the above named defendant so that, on or before July 1, 1974 defendant shall serve upon Louis J. Finger, Esquire, plaintiff's attorney whose address is 4072 DuPont Building, Wilmington, Delaware 19899 an answer to the complaint.

Exhibit D Annexed to Affidavit of Mallis and Kupferman.

To serve upon defendant a copy hereof and of the complaint.

Dated May 20, 1974

(Illegible)
Register in Chancery

TO THE ABOVE NAMED DEFENDANT:

In case of your failure, on or before July 1, 1974 to serve on plaintiff's attorney named above an answer to the complaint, judgment by default will be rendered against you for the relief demanded in the complaint.

(Illegible
Register in Chancery

Exhibit D Annexed to Affidavit of Mallis and Kupferman.

COMPLAINT.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

Civil Action No. 4510

EQUITY NATIONAL INDUSTRIES, INC., a corporation of the State of Delaware,

Plaintiff,

v.

JEROME B. KATES, JUDITH KATES, MURRAY BERLINER, VITO DOINO, LILLIAN COLLICA, SAMUEL MALLIS, JACK J. ARNOLD, and FRANKLIN NATIONAL BANK, a corporation of the State of New York,

Defendants.

1. Plaintiff (hereinafter referred to as "Equity") is a corporation of the State of Delaware with its principal place of business at Atlanta, Georgia.

2. Plaintiff entered into an Agreement and Plan of Reorganization dated July 23, 1970, with Equity-Take Two, Inc., a Georgia corporation (hereinafter referred to as the "Subsidiary") and Take Two, Inc., a New York corporation (hereinafter referred to as "Take Two"). Said agreement was amended by a further agreement between the parties made as of October 30, 1970.

3. On August 7, 1970, Subsidiary and Take Two entered into a Plan and Agreement of Merger pursuant to which

Exhibit D Annexed to Affidavit of Mallis and Kupferman.

Take Two would be merged into Subsidiary and the stockholders of Take Two would receive shares of stock of Equity. An amended Plan and Agreement of Merger was made as of October 30, 1970, between Take Two and Subsidiary providing for the merger of Take Two into Subsidiary and the issuance to the shareholders of Take Two of shares of stock of Equity, but on revised terms. The Agreement and Plan of Reorganization, the amendment thereto, the Plan and Agreement of Merger, and the amended Plan and Agreement of Merger, together with the 1970 Escrow Agreement hereinafter referred to, constituted a single unified plan (hereinafter referred to as "the Plan") under which the stockholders of Take Two were to receive shares of stock of Equity, and Take Two was to become a wholly-owned subsidiary of Equity.

4. Defendants Jerome B. Kates, Judith Kates, Murray Berliner, Vito Doino and Lillian Collica are some of the former shareholders of Take Two who received shares of stock of Equity pursuant to the Plan.

5. Defendants Samuel Mallis and Jack J. Arnold are transferees of shares of Equity acquired by defendants Jerome B. Kates and Judith Kates pursuant to the Plan.

6. Defendant Franklin National Bank is a pledgee of stock of Equity issued to Jerome B. Kates and Judith Kates pursuant to the Plan.

7. All of the individual defendants reside outside of the State of Delaware and defendant Franklin National Bank is a New York corporation which does not do business and is not registered to do business in the State of Delaware. The addresses of all defendants are set forth in the Affidavit of Louis J. Finger attached hereto.

8. Under the Plan, each share of stock of Take Two was to be exchanged for .64815 shares of Common Stock of Equity, to be adjusted upward or downward pursuant to a formula related to earnings of Take Two for the calendar year 1970 (with further adjustments related to earnings of Take Two for the calendar years 1971, 1972, 1973 and 1974, and also with certain adjustments relating to the market price of the Common Stock of Equity during the month of December, 1971). The Plan provided that a percentage of the basic .64815 shares issued in exchange for each share of Take Two would be delivered to the stockholders of Take Two as "Conditional Shares", and the balance of the .64815 shares, plus sufficient shares to cover such additional amounts to which the stockholders of Take Two might become entitled pursuant to the Plan were to be deposited with National Bank of Georgia as Escrow Agent pursuant to an Escrow Agreement with Equity, the Subsidiary, and the stockholders of Take Two. The Escrow Agreement (hereinafter referred to as "the 1970 Escrow Agreement") was actually dated August 7, 1970, and amended October 30, 1970.

9. Pursuant to the Plan, those stockholders of Take Two who are named as defendants herein received the following number of conditional shares at the closing:

Jerome B. Kates	29,821
Judith Kates	10,563
Murray Berliner	493
Lillian Collica	23
Vito Doino	59

10. Pursuant to the Plan, each certificate evidencing the conditional shares received by the defendants bears a

legend to the effect that the conditional shares are subject to the provisions of the 1970 Escrow Agreement and may not be sold, transferred, pledged or hypothecated except in accordance with the provisions of the 1970 Escrow Agreement.

11. Because Take Two had no net earnings before taxes for the calendar year 1970, the shareholders of Take Two were not entitled under the Plan to any additional shares and were required, pursuant to the Plan, to return to Equity all the conditional shares issued to them.

12. The shareholders of Take Two other than those named as defendants herein, have all returned the conditional shares received by them to Equity, but the shareholders of Take Two named herein as defendants, have failed and refused to do so, although Equity has demanded the shares of them.

13. The interest of defendants Franklin National Bank, Samuel Mallis and Jack J. Arnold as transferees or pledgees was received with full notice of the terms of the Plan by reason of the legend inscribed upon those shares pursuant to 8 Del.C. § 202.

14. Because the stockholders were not entitled to the shares referred to in paragraph 9 herein, such shares should be cancelled and declared by this Court to be void.

15. Plaintiff has no adequate remedy at law.

WHEREFORE, Plaintiff prays:

A. That the defendant be required to answer the Complaint, and that an Order be made pursuant to 10 Del.C. § 365 for the appearance of the defendants.

Exhibit D Annexed to Affidavit of Mallis and Kupferman.

B. That this Court declare the shares referred to in paragraph 9 of this Complaint to be cancelled and void.

C. That a restraining order and preliminary injunction issue pending the disposition of this action, restraining and enjoining each of the defendants from transferring, pledging or otherwise allowing any other person or entity to acquire rights in the shares referred to in paragraph 9 of this Complaint.

D. That defendants be permanently enjoined from transferring, pledging or otherwise allowing any other person or entity to acquire rights in the shares referred to in paragraph 9 of this Complaint and the defendants be required to surrender and deliver to the plaintiff the certificates evidencing such shares.

E. That plaintiff receive its costs and attorney's fees.

F. That the Court make such other orders for relief as are just in the premises.

LOUIS J. FINGER
LOUIS J. FINGER
Richards, Layton & Finger
4072 DuPont Building (Box 551)
Wilmington, Delaware 19899
Attorney for Plaintiff

Dated: May 16, 1974

Affidavit of Noel W. Hauser, in Support of Motion for Temporary Restraining Order.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK
COUNTY OF KINGS } ss.:

NOEL W. HAUSER, being duly sworn, deposes and says:

That in accordance with Rule 65 of the Federal Rules of Civil Procedure, I telephoned the defendants, Federal Deposit Insurance Corporation, European American Bank & Trust Company and Franklin National Bank, on February 24, 1975 to advise that I would forthwith be making application for a temporary restraining order restraining the negotiation of negotiable instruments and other evidences of debt and renewals thereof executed by plaintiffs in favor of said defendants.

I so advised Douglas Jones, Counsel for the defendant Federal Deposit Insurance Corporation and Mr. Jassy, general counsel to European American Bank & Trust Company between 11:30 and 11:45 A.M. on February 24, 1975. Upon telephoning the Franklin National Bank at three of its listed telephone numbers in the Manhattan phone directory, I was referred in one instance to the European American Bank & Trust Company, and in the two other instances, the telephone was not answered.

In conjunction with the plaintiff's application for a temporary restraining order, I am attaching hereto as an exhibit a letter dated March 3, 1972 from Jack J. Arnold, addressed to the plaintiff Samuel Mallis, confirming an agreement that Mallis was to advance the sum of $156,-

728.00 toward the purchase of 40,384 shares of Equity National Industries, Inc. This letter was apparently received by John Murfitt in the closing to which the affidavit of the plaintiffs, hereto annexed, refers.

The aforesaid letter was not referred to in the affidavit of the plaintiffs for the reason that in preparing the papers for signature and execution by plaintiffs, the letter was not available. However, I am advised by the plaintiffs that this letter was received by them as part of the closing documents.

No previous application for the relief herein requested has been made.

NOEL W. HAUSER

(Sworn to February 24, 1975.)

Exhibit Annexed to Affidavit of Noel W. Hauser.

LETTERHEAD OF JACK J. ARNOLD

March 3rd, 1972

Dr. Samuel Mallis
Roslyn, New York

Dear Dr. Mallis:

This letter is to confirm the agreement and understanding with Mr. John B. Fowler and myself as respects your participation in the purchase of 40,384 shares of Equity National Industries, Inc. You are to advance the sum of $156,728.00 towards the purchase price of $181,728.00, the sum of $25,000.00 already having been paid as a binder deposit on the purchase of the Eqity shares.

The shares are to be held as collateral by you. It is agreed that within thirty days or less you shall be reimbursed the funds advanced by you plus a profit of fifty (50,000.00) thousand dollars for your participation in this trade. Upon the remittance to you of your investment plus fifty thousand dollars you will deliver the shares to Jack J. Arnold free of any incumerances.

There is currently pending a transfer pursuant to a written option a block of 100,000 shares of Merck & Co., Inc. out of which proceeds you will be reimbursed for the total sum of money accruing to you. This transfer will be completed during March, 1972.

Very truly yours

Jack J. Arnold, as attorney
John B. Fowler

Answer of Defendant Bankers Trust Company.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

ANSWER

The defendant, Bankers Trust Company, by its attorney, Charles Leeds, answering the plaintiffs' Complaint herein, respectfully shows and alleges:

1. Denies each and every allegation in Paragraphs designated as "Twenty-first," "Twenty-second," "Twenty-third," "Twenty-fourth" and "Twenty-fifth."

AS AND FOR A FIRST AFFIRMATIVE DEFENSE

2. The Complaint fails to state a cause of action against this defendant upon which relief can be granted.

AS AND FOR A SECOND AFFIRMATIVE DEFENSE

3. Plaintiffs are collaterally estopped from bringing this action against the defendant, Bankers Trust Company, by reason of the fact that in a prior action in the Supreme Court of the State of New York, County of New York entitled "SAMUEL MALLIS v. JEROME B. KATES, JUDITH KATES, BANKERS TRUST COMPANY, et als"—Index No. 25831/1972, a Judgment was rendered in favor of this defendant and against the plaintiff, dismissing plaintiff's Complaint upon the merits, and the issues, if any, in the present case were or could have been litigated in the said prior Supreme Court action, and therefore should not be re-litigated herein.

AS AND FOR A THIRD AFFIRMATIVE DEFENSE

4. In a prior action instituted by the plaintiff, Samuel Mallis, against this defendant in the Supreme Court as hereinabove alleged in the Second Affirmative Defense, a Judgment dismissing plaintiff's Complaint upon the merits was rendered in favor of this defendant and against the plaintiff, Samuel Mallis. The said determination in the prior Supreme Court action is res judicata in this action and the plaintiffs are therefore bound by the said Supreme Court Judgment.

AS AND FOR A FOURTH AFFIRMATIVE DEFENSE

5. The plaintiffs were and are total strangers to any dealings with and transactions had between the defendant, Bankers Trust Company, and Jerome and Judith Kates. The plaintiffs have no claim against this defendant since there never was any privity of contract or otherwise between these plaintiffs or either of them with respect to any transactions between the defendant, Bankers Trust Company, and the said Jerome and Judith Kates.

AS AND FOR A FIFTH AFFIRMATIVE DEFENSE

6. There was no duty on the part of the defendant, Bankers Trust Company, to advise plaintiffs as to the validity of the subject shares of stock which plaintiffs purchased from Jerome and Judith Kates, since there was no relationship between plaintiffs and this defendant; any damage alleged to have been suffered by plaintiffs was brought about by their own negligence in their failure to investigate the subject shares of stock.

Answer of Defendant Bankers Trust Company.

WHEREFORE, defendant, Bankers Trust Company, demands Judgment dismissing the plaintiffs' Complaint herein, together with the costs and disbursements of this action.

Dated: New York, N.Y.
April 7, 1975

/s/ CHARLES LEEDS
CHARLES LEEDS, Esq.
Attorney for Defendant,
Bankers Trust Company
1775 Broadway
New York, New York 10019
MUrray Hill 2-5888/9

Affidavit of Nathan Silverman, Sworn to April 25, 1975.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

NATHAN SILVERMAN, being duly sworn, deposes and says:

That I am an Attorney at Law associated with Charles Leeds, the attorney for the Defendant, Bankers Trust Company.

That I submit this Affidavit at the direction of Judge Pollack to furnish Plaintiffs' Attorney with factual information in order to enable him to respond to the same on or before May 5, 1975.

The facts upon which the Defendant, Bankers Trust Company, relies for summary judgment dismissing Plaintiffs' complaint are set forth with particularity in an action instituted by Plaintiffs against this Defendant in the Supreme Court in the State of New York, County of New York under Index No. 25831/1972 and the papers, Affidavits, pleadings, etc., on file in said action are incorporated herein by reference.

.....
NATHAN SILVERMAN

(Sworn to April 25, 1975.)

Notice of Motion to Dismiss Cause of Action, Dated February 20, 1973.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

SAMUEL MALLIS,

Plaintiff

—against—

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR., EQUITY NATIONAL INDUSTRIES, INC., EQUITY-TAKE TWO, INC., THE NATIONAL BANK OF GEORGIA, BANKERS TRUST COMPANY and WILLIAM LONDON,

Defendants

Index No. 25831/72

IC PTS

NOTICE OF MOTION TO DISMISS CAUSE OF ACTION

SIR:

PLEASE TAKE NOTICE, that upon the annexed affidavits of Nathan Silverman and Jack Jasper, sworn to on the 12th day of January, 1973, and upon the Summons and Complaint heretofore served herein, a motion pursuant to CPLR 3211(a) (7) will be made at an IC Part 8 of this Court, before Mr. Justice Nadel, to be held at the Courthouse thereof, located at 60 Centre Street, City and State of New York, in Room 412, on the 7th day of March, 1973, at 10:00 A.M., for a Judgment dismissing the plaintiff's Complaint as against the defendant, Bankers Trust Company, on the ground that the said Complaint fails to state a cause of action as against the defendant, Bankers Trust Company, and for such other and further relief as may be just, proper and equitable.

Notice of Motion to Dismiss Cause of Action, Dated February 20, 1973.

PLEASE TAKE FURTHER NOTICE, that pursuant to Rule 2214 (b) CPLR, affidavits and Memorandum of Law, if any, to be used in answering this motion are required to be served on the undersigned at least five (5) days before the hearing.

Dated: New York, N.Y.
February 20, 1973

YOURS, ETC.,

CHARLES LEEDS
Attorney for Defendant,
Bankers Trust Company
1775 Broadway
New York, New York 10019
MUrray Hill 2-5888/9

To: RUBEN SCHWARTZ, Esq.
ABRAHAM EPSTEIN, Of Counsel
Attorney for Plaintiff
450 Seventh Avenue
New York, New York 10001

Affidavit of Jack Jasper in Support of Motion to Dismiss Cause of Action.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

JACK JASPER, being duly sworn, deposes and says:

That I am an Assistant Treasurer assigned to the Delancey Street branch of Bankers Trust Company (herein "Bankers").

That I am the loan officer who transacted business with the defendant, Jerome B. Kates (herein "Kates").

That in and about the month of August, 1970, Kates applied for a $50,000.00 loan. He offered as collateral, 40,384 shares of the stock of Equity National Industries, Inc. (herein "Equity"). The shares of stock which he offered were legended stock, and before your deponent would approve and accept the same as collateral, your deponent requested and did obtain from Kates an opinion letter dated August 25, 1970, from a reputable firm of New York attorneys concerning the conditions of the Escrow Agreement set forth in the legend appearing on the stock certificates. This firm of attorneys, and I will be pleased to submit their names if the Court should so desire, rendered an opinion that practically all of the conditions of the Escrow Agreement had been complied with and that the stock would become eligible for public sale without registration six (6) months after August 7, 1970.

Relying upon such opinion letter, I approved the loan and Bankers accepted the Equity stock as collateral for

repayment of the $50,000.00 loan made to Kates and his wife, Judith. I definitely considered the stock as valuable, otherwise, it would have been folly and a violation of my duties as a loan officer to make such a loan, collateralized by "worthless" stock. Thereafter, I was told by defendant Kates that the restrictions were no longer effective and that all of the conditions in the Escrow Agreement which appeared on the legended stock had been fully complied with. I therefore considered this collateral as valuable.

Inasmuch as Kates was reducing his indebtedness by monthly payments, having reduced the loan from $50,000.00 to $45,000.00, the Bank took no action to sell the collateral.

For plaintiff to allege that Bankers knew that the legended Equity stock was "worthless" is a gratuitous statement not borne out by the facts.

There was never any confidential or fiduciary relationship between plaintiff and Bankers. I am advised by counsel that there was no duty on the part of Bankers to speak, namely, to advise plaintiff or his representative as to the value of the stock even assuming, arguendo, we knew the value thereof. I am further advised by counsel for Bankers that the plaintiff's Complaint is vulnerable to attack for insufficiency in that there is no basis both in law and in fact, to assess liability against Bankers for "silent acquiescence."

I therefore join with our attorney on the motion to dismiss plaintiff's Complaint for failure to state facts sufficient to constitute a cause of action against Bankers.

/s/ JACK JASPER
Jack Jasper

(Sworn to January 12, 1973.)

Affidavit of Nathan Silverman in Support of Motion to Dismiss Cause of Action.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

NATHAN SILVERMAN, being duly sworn, deposes and says:

1. That I am an attorney at law associated with Charles Leeds, the attorney for the defendant, Bankers Trust Company (herein "Bankers"), and am fully familiar with the facts and circumstances herein.

2. I make this affidavit in support of a motion by defendant, Bankers to dismiss plaintiff's Complaint for failure to state facts sufficient to constitute a cause of action, on which motion, pursuant to CPLR 3211 subd.(c), a party may submit evidence that could properly be considered on a motion for summary judgment and the Court may treat the motion to dismiss as a motion for summary judgment. The Summons and Complaint were served on Bankers on December 11, 1972; no Answer has been interposed by Bankers. A copy of the Complaint is annexed hereto and marked as Exhibit "A".

3. Your deponent is the attorney for Bankers who attended the closing on March 3, 1972, referred to in the Complaint. The closing took place at our office at 750 Third Avenue, New York, N.Y. At this closing, the defendant, Jerome B. Kates (herein "Kates"), sold to plain-

tiff the shares of stock of Equity National Industries, Inc. (herein "Equity") which shares of stock were held as collateral by Bankers for the repayment of a loan made by Bankers to Kates and his wife.

4. The facts and circumstances surrounding this transaction are as follows:

5. Prior to March 3, 1972, deponent was informed by Jack Jasper, the officer of Bankers who serviced the Kates account and whose affidavit is annexed hereto, that Kates had a purchaser for the Equity stock which he had given to Bankers as collateral for Kates' loan. I told Mr. Jasper, the Bank officer, that he should forward the stock certificates to your deponent and we would make available to Kates the use of our office where he could bring his purchaser, and upon payment of the balance due on his loan, the stock certificates of Equity would be released and returned to Kates simultaneously with such payment.

6. On March 3, 1972, the following persons came to our office to close this matter: the defendant Kates, John B. Fowler, Jr., a stockbroker (sued herein), Jack J. Arnold (sued herein), the attorney representing the *purchaser*, plaintiff herein, and John A. Murfitt, an Assistant Vice President of Franklin National Bank where the purchaser had an account, and who was to provide the funds for such purchase. The said representative of Franklin National Bank brought with him official checks to pay for the purchase of the said stock. I might mention as stated above, that our office was offered as a facility to accommodate the parties involved. I did not know and I was never told the name of the purchaser, nor was I interested. Also, I did not know whether the stockbroker Fowler represented Kates or whether he represented the purchaser, and again, I was not interested. I merely stood on the "sidelines"

while the aforementioned persons finalized their deal. I do know that attorney Arnold requested an affidavit from Kates with respect to the legend which appeared on the stock certificates.

7. I annex hereto and mark as Exhibit "B" a photocopy of one of the stock certificates for 29,821 shares of stock of Equity issued to Kates (the other stock certificate for 10,563 shares of Equity was issued in the name of Judith Kates, wife of the defendant Kates, also sued herein). The Court can readily observe that the legend appearing on the reverse side of the said certificate is as big as life and certainly called for an inquiry with respect to the same, which was done by attorney Arnold, representing the purchaser.

8. After receipt by attorney Arnold of an affidavit concerning the legended stock in question, Mr. Murfitt of Franklin National Bank wrote out several official checks and delivered one check of $45,000.00 to our deponent in payment of the balance due Bankers on Kates' loan. I called the attention of Mr. Murfitt, that he Murfitt, drew the said check payable to Kates and Bankers, and I could not accept the same as Bankers was not a party to the transaction involved. He thereupon struck out the name of Bankers as co-payee, initialed such change, and delivered the same to Kates who endorsed it over to Bankers, whereupon I released and turned over to Kates the two (2) stock certificates of Equity evidencing 40,384 shares of Equity. I annex hereto and mark as Exhibit "C" a photocopy of the official check of Franklin National Bank which indicates that it was payable to Kates and the name of Bankers crossed out and initialed by Mr. Murfitt.

9. In this action, the gravamen of plaintiff's Complaint is that Bankers aided and abetted a conspiracy on the

part of Kates, Fowler, plaintiff's own attorney Arnold, as well as the other defendants sued herein, by *"silent acquiescence"* in that Bankers did not advise plaintiff's attorney that the legended Equity stock was "worthless." This is a very *ingenious* theory conjured up by the plaintiff in an endeavor to bring in a financial institution such as Bankers, and visit upon Bankers the sin of malpractice charged by plaintiff against his own attorney sued in this very action. Indeed, I am very much surprised that the plaintiff did not charge his own bank, Franklin National Bank, with misfeasance, malfeasance or what have you.

10. Your deponent will submit to the Court upon this motion, a Memorandum of Law which will convince this Court beyond a shadow of a doubt that there was no duty on the part of Bankers to "speak" and advise plaintiff's attorney that the legended Equity stock was "worthless," even if this were true, because there was *no confidential* or *fiduciary relationship* between Bankers and plaintiff. Although not germane to the issue of liability on the part of Bankers, there is no proof that Bankers knew that the Equity stock was "worthless." On the contrary, as will be seen from the annexed affidavit of Jack Jasper, the Equity stock was considered valuable when accepted as collateral, and continued to be so considered up to the time of the closing on March 3, 1972.

11. The Equity stock was selling on the American Stock Exchange on March 3, 1972, at $12.00 per share which computed on the basis of 40,384 shares, held by Bankers as collateral, amounted to $484,608.00. I can only speculate that if plaintiff paid $156,728.00 for 40,384 shares selling at $484,608.00 at the prevailing market on March 3, 1972, he felt that he was getting a terrific bargain, and must have been anxious to make the deal. If he was

defrauded, liability if any, lies at the doorstep of persons and parties other than Bankers. Plaintiff is not a "babe in the woods;" he is a sophisticated person, a dentist by profession as I am informed, and was represented by his own attorney Arnold, a practitioner of thirty-five (35) years standing at the Bar.

12. I respectfully submit that both in law and in fact, the plaintiff has failed to state facts sufficient to constitute a cause of action against Bankers, and I respectfully urge that plantiff's Complaint be dismissed with costs.

/s/ NATHAN SILVERMAN
NATHAN SILVERMAN

(Sworn to January 12, 1973.)

Complaint in State Court Action.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

[SAME TITLE]

COMPLAINT

Plaintiff, complaining of the defendants, by Ruben Schwartz, Esq. respectfully show to this Court and allege:

AS AND FOR A FIRST CAUSE OF ACTION AGAINST ALL DEFENDANTS:

FIRST: That upon information and belief, at all of the times hereinafter mentioned, the defendant Equity National Industries, Inc. (hereinafter called "National"), was and still is a Delaware corporation.

SECOND: That upon information and belief, at all of the times hereinafter mentioned, Equity-Take Two, Inc. (hereinafter called "Take-Two"), was and still is a Georgia Corporation.

THIRD: That upon information and belief, at all of the times hereinafter mentioned, the defendant The National Bank of Georgia (hereinafter called "Escrowee") was and still is a National Banking Corporation organized and existing under and by virtue of the laws of the State of Georgia.

FOURTH: That upon information and belief, at all of the times hereinafter mentioned, the defendant Bankers Trust Company (hereinafter called "Bankers") was and still is

a Banking Corporation organized and existing under and by virtue of the laws of the State of New York.

FIFTH: That upon information and belief, at all of the times hereinafter mentioned, the defendant Jack J. Arnold (hereinafter called "Arnold") was and still is an attorney and counsellor at law duly licensed to practice his profession in the State of New York.

SIXTH: That upon information and belief, at all of the times hereinafter mentioned, the defendant William London (hereinafter called "London") was and still is an attorney and counsellor at law duly licensed to practice his profession in the State of New York.

SEVENTH: That at all of the times hereinafter mentioned, each of the defendants "Arnold" and "London" held themselves out as skillful and honorable practitioners of the law, experienced in the handling and closing of stock sale transactions and practicing in accordance with the canons of ethics adopted or promulgated by the Association of the Bar of the State of New York.

EIGHTH: That upon information and belief, at all of the times herein mentioned, the defendant John B. Fowler, Jr. (hereinafter called "Fowler") was an officer and employee of J.S. Love and Company, Inc., stockbrokers, and was a joint venturer with the defendant "Arnold".

NINTH: That at all of the times hereinafter mentioned, the defendants Jerome B. Kates and Judith Kates, (hereinafter collectively called "Kates") were the owners of record of 40,384 shares of stock of the defendant "National" represented by stock certificates bearing #U1828 and #U1833 of the par value of $1.00 each.

TENTH: That upon information and belief, at all of the times herein mentioned the aforesaid shares of stock so owned by the defendants "Kates" had been and still were the subject of a certain escrow agreement dated on or about the 7th day of August, 1970, by and between the defendant "Take-Two" and the "Escrowee".

ELEVENTH: That upon information and belief, on the 30th day of October, 1970, there was executed by and between the aforesaid defendants "National", "Take-Two", the "Escrowee" and one Stanley C. Lesser as Nominee, an amendment to the aforesaid escrow agreement, wherein and whereby, among other things, the aforesaid 40,384 shares of stock represented by Certificates #U1828 and #U1833 were to be held in escrow by the Escrowee, pending the occurrence of the certain conditions set forth and described in said escrow agreement and the amendment thereto, as well as the certain restrictions and limitations endorsed on the body of said stock certificates.

TWELFTH: That upon information and belief, at all of the times herein mentioned, the aforesaid shares of stock represented by Certificate #U1828 and #U1833 were never delivered to the custody and possession of the Escrowee or in breach of the terms and conditions of said escrow agreements and without authority were released from the possession of the Escrowee into the possession and control of the defendants "Kates".

THIRTEENTH: That upon information and belief, the aforesaid defendants "Kates" subsequently pledged and delivered the aforesaid certificates of stock bearing #U1828 and #U1833 to the defendant Bankers Trust Company, its agents, servants and employees as collateral, for a certain loan made by said defendant Bankers Trust Company to the defendants "Kates".

FOURTEENTH: That upon information and belief, at all of the times herein described and hereinafter mentioned, each of the aforesaid certificates of stock bearing #U1828 and #U1833 of the defendant Equity National Industries Inc. bore the following legend in bold type across the margin thereof:

"The shares evidenced by this certificate are subject to the provisions of an Escrow Agreement dated August 7, 1970 among the Corporation, Equity-Take Two, Inc., The National Bank of Georgia and Stanley C. Lesser, as nominee for the former shareholders of Take Two, Inc., and may not be sold, transferred, pledged or hypothecated except in accordance with such Escrow Agreement, a copy of which may be examined at the office of the Corporation."

FIFTEENTH: That upon information and belief, at all of the times herein mentioned, each of the defendants named herein, had notice and knowledge of the existence of the above quoted restrictions upon the sale, transfer or encumbrancing of such stock certificates bearing #U1828 and #1833, and were fully aware, or should have known, of the terms, conditions and provisions of the escrow agreement and amendment thereto.

SIXTEENTH: That upon information and belief, in or about the month of February, 1972, the defendants "Kates" entered into an unlawful agreement and conspiracy with the defendants "Arnold" and "Fowler", wherein and whereby, among other things, they conspired and agreed to cheat, swindle and defraud the plaintiff, Samuel Mallis, and in furtherance of said conspiracy and unlawful agreement and to effectuate the purpose thereof, did and performed the following overt acts:

(a) Falsely and fraudulently represented, that the certificates of stock bearing #U1828 and #1833 were free and

clear of any restrictions or encumbrances thereon, and had been released from the escrow described in the agreement and amendment thereto.

(b) Falsely and fraudulently represented to plaintiff, that the aforesaid shares of stock would fairly, reasonably and adequately serve as collateral for the return to plaintiff of the amount of their investment and the profit of $50,000. within 30 days of the purchase of said stock, and that upon default of such payments, plaintiff would have title to and own such stock free of any restrictions, liens or encumbrances.

(c) They further fraudulently and untruthfully represented to the plaintiff that there was currently pending, at the option of the defendants "Arnold" and "Fowler" a purchase by them of a block of 100,000 shares of Merck & Co. Inc. at an advantageous price, from the proceeds of the sale of which, the sums of money so invested by the plaintiff and profit would be further secured, collateralized and repaid.

(d) The defendants "Kates", "Arnold" and "Fowler" among others attended a closing on the 3rd day of March, 1972, at the premises of the Bankers Trust Company, 750 Third Avenue, New York City, New York, wherein and whereby the defendants "Kates" falsely and fraudulently represented that the shares of stock bearing #U1828 and #1833 to be transferred at such closing had previously been released from the escrow agreement and amendment thereto, and that said escrow agreement in no way restricted or encumbered the negotiability of the stock.

(e) Acting in concert with the other defendants, and as part of the aforesaid fraud and swindle, the defendant "Arnold" in his capacity as an attorney and counsellor at law, pretended to accept the aforesaid statements and rep-

resentations of the defendants "Kates" as true, although the defendants knew that the aforesaid statements were false and fraudulent and without any legal effect of any kind, nature or description.

SEVENTEENTH: That upon information and belief, at all of the times herein mentioned, and at the time of such closing, the defendant "Bankers", its agents, servants and employees were fully aware that the restrictions of the sale of said stock were in full force and effect, the escrow agreements fully binding and conclusive on the parties thereto, and that the defendants "Kates" had no legal right to sell, transfer or assign such stock certificates free and clear of encumbrances, but remained silent, and failed to disclose such knowledge to the plaintiff or his representatives.

EIGHTEENTH: That upon information and belief, the defendant "Bankers" aided and abetted the conspiracy and swindle, for the purpose of securing the repayment of its loan from the defendants "Kates" and for that reason assisted the conspirators in foisting off worthless collateral consisting of stock certificates #U1828 and #1833 upon the plaintiff by its silent acquiescence and participation in the closing which took place at its office, and its acceptance of the "investment" of plaintiff or a portion thereof in liquidation of its loan to "Kates".

NINETEENTH: That upon information and belief, the defendant "Escrowee" contributed to the aforesaid conspiracy and fraud by unlawfully, and without authority, and in breach of the escrow agreement and amendment thereto, first referred to, releasing from its possession and custody the aforesaid stock certificates #U1828 and #1833 representing the shares of stock which were the subject of the escrow, prior to the occurrence of the conditions

described therein, and delivering physical possession of such certificates with apparent power of hypothecation to the defendants "Kates".

TWENTIETH: That upon information and belief, the defendant "London" contributed to the aforesaid damage of the plaintiff and aided and abetted the aforesaid conspiracy and fraud, in that he had notice and knowledge acquired by him as an attorney at law associated with the former attorneys for the defendants "Kates", of the existence of the escrow agreements referred to above, their terms and conditions, and was fully aware of the restrictions, encumbrances and limitations of said stock, its sale or hypothecation on and before the 24th day of February, 1972.

TWENTY-FIRST: That despite such notice and knowledge, and aware of the restrictions on the sale or transfer of such stock, he acted as counsel to the defendants "Kates", in the negotiation, preparation and execution of the certain documents pertaining to the ostensible sale of such stock to the defendant "Arnold", wherein representations and warranties were made by the defendants "Kates" certifying the negotiabilty of said stock certificates, their lack of encumbrances and the sellers' good title thereto.

TWENTY-SECOND: That upon information and belief, he failed and neglected to disclose to the plaintiff, the information which he possessed, but remained silent when there was a duty upon him to speak.

TWENTY-THIRD: That upon information and belief, the defendants "National" and "Take-Two", their agents, servants and employees participated, joined, aided and abetted the aforesaid illegal scheme, conspiracy and fraud, in that having executed the escrow agreements, first re-

ferred to, thereby having imposed restrictions on the sale or transfer of such stock certificates, they permitted and allowed physical possession of the certificates to be and remain in the hands of the defendants "Kates", with ostensible and apparent authority to negotiate and hypothecate the same.

TWENTY-FOURTH: That each of the representations of the defendants above set forth were false, fraudulent and untrue, and were either known to be false when made or were made so recklessly and without heed to the consequences, as to constitute fraudulent statements.

TWENTY-FIFTH: Contrary to the aforesaid representations of the defendants, the stock was subject to the restrictions imposed by the escrow agreements; had not been released therefrom; nor was the stock negotiable, transferable or salable, free from encumbrance, restriction or limitation, nor did the defendants "Kates" or other defendants have good, marketable, unencumbered title thereto, free and clear of any liens.

TWENTY-SIXTH: That the plaintiff believed the representations of the defendants, relied on them, and would not have entered into the aforesaid transaction, had he been aware of the falsity thereof.

TWENTY-SEVENTH: That upon information and belief, each of the defendants entered into and participated in the aforesaid conspiracy and unlawful agreement to cheat, defraud and swindle the plaintiff and did and performed the overt acts above described for said purpose and in furtherance of the conspiracy.

TWENTY-EIGHTH: That by reason of the premises plaintiff, was deprived of the investment of $156,728, together

with the sum of $50,000 profit, making a total of $206,728, no part of which has been paid, except the sum of $50,000, leaving a balance due and owing in the sum of $156,728 with interest from the 3rd day of March, 1972.

AS AND FOR A SECOND CAUSE OF ACTION AGAINST THE DEFENDANTS JACK J. ARNOLD AND JOHN B. FOWLER, JR.

TWENTY-NINTH: Plaintiff repeats, reiterates and realleges each and every allegation contained in the first cause of action as paragraphs "FIRST" through "FOURTEENTH", inclusive, with the same force and effect as if more fully set forth at length herein.

THIRTIETH: That on or about the 3rd day of March, 1972, for good and valuable consideration, the defendants "Arnold" and "Fowler" entered into a contract with the plaintiff, wherein and whereby, among other things, they agreed to pay to the plaintiff the sum of $156,728, his investment, together with the sum of $50,000 profit, within 30 days of the date of such agreement, and further agreed to deliver to the plaintiff 40,384 shares of the stock of the defendant "National" without any restrictions or limitations on its sale and negotiation and having a market value of approximately $500,000 as security and collateral for such payments.

THIRTY-FIRST: That in breach of said contract, and in violation of the terms thereof, defendants "Arnold" and "Fowler" failed, neglected and refused to make such payments of investment and profit, and failed to deliver to plaintiff 40,384 shares of National stock as agreed, unrestricted and unlimited as to negotiability and transfer, but on the contrary delivered to the plaintiff stock certificates representing such shares, so restricted and so limited as to make them absolutely worthless.

THIRTY-SECOND: That by reason of the premises, plaintiff sustained damage in the sum of $206,728, no part of which has been paid except the sum of $50,000, leaving a balance due and owing to the plaintiff in the sum of $156,728 with interest from the 3rd day of March, 1972.

AS AND FOR A THIRD CAUSE OF ACTION AGAINST THE DEFENDANT, JACK J. ARNOLD.

THIRTY-THIRD: Plaintiff repeats, reiterates and realleges each and every allegation contained in paragraphs of the complaint designated "FIRST" through "FOURTEENTH" inclusive with the same force and effect as if more fully set forth at length herein.

THIRTY-FOURTH: That the defendant "Arnold" was guilty of negligence and malpractice in that he failed to secure on behalf of the plaintiff unrestricted and unlimited stock; in that he failed to take the usual normal reasonable precautions to secure on behalf of the plaintiff, a valid title to unrestricted and unlimited stock having a value reasonably related to the sums of money it was intended to secure, but on the contrary accepted documents representations and papers from the defendant "Kates" wholly inadequate for such purpose; in that he failed to exercise reasonable skill in the practice of his profession or to take such precautions as would normally be taken by a practicing attorney in the City and State of New York to secure unrestricted and unlimited stock as collateral; that he recklessly and carelessly failed to heed the plain endorsement of the legend on the stock certificates which indicated that said stock was restricted and limited as to negotiability and transfer; that contrary to the canons of ethics promulgated and/or adopted by the Association of the Bar of the State of New York, the said defendant

while purporting to represent and act on behalf of the plaintiff, acted in his own and conflicting interest; and in that the said defendant was otherwise careless, reckless and negligent in the premises, all to the damage of the plaintiff in the sum of $156,728.

AS AND FOR A FOURTH CAUSE OF ACTION AGAINST THE DEFENDANTS JEROME B. KATES, JUDITH KATES AND WILLIAM LONDON.

THIRTY-FIFTH: Plaintiff repeats, reiterates and realleges each and every allegation contained in paragraphs of the complaint designated "FIRST" through "FOURTEENTH" inclusive with the same force and effect as if more fully set forth at length herein.

THIRTY-SIXTH: That the defendants "Kates" and "London" knew and were well aware that the 40,384 shares of National stock transferred from the defendant "Kates" to the defendant "Arnold" by the purchase agreement of the 24th day of February, 1972 were restricted and limited as to their negotiability, transfer and sale.

THIRTY-SEVENTH: That the defendants and each of them were guilty of fraudulent concealment in failing to disclose such fact to the defendant "Arnold" and/or the plaintiff.

THIRTY-EIGHTH: That said fraudulent concealments was practiced by said defendants "Kates" for the express purpose of cheating and swindling the plaintiff herein, knowing full well that he would rely on the statements made to him that the stock was free from any limitations or restrictions on its negotiability or transfer, and defendant "London" aided and abetted defendant "Kates", by his silence and failure to speak.

THIRTY-NINTH: That by reason of the aforesaid fraudulent concealment plaintiff sustained damage in the sum of $156,728. plus interest from the 3rd day of March, 1972.

AS AND FOR A FIFTH CAUSE OF ACTION AGAINST ESCROWEE, NATIONAL AND TAKE-TWO.

FORTIETH: Plaintiff repeats, reiterates and realleges each and every allegation contained in paragraphs of the complaint designated "FIRST" through FOURTEENTH" inclusive with the same force and effect as if more fully set forth at length herein.

FORTY-FIRST: That each of the defendants above described were negligent in that having executed between them an escrow agreement and amendment thereto, wherein and whereby the aforesaid 40,384 shares of "National" stock were to be held in escrow by the "Escrowee" pending the conditions for release described therein, they allowed and permitted the aforesaid stock certificates #U1828 and #U1833, representing the aforesaid 40,384 shares of "National" stock to leave the possession of the "Escrowee" and to be delivered instead to the possession of the defendants "Kates", placing him in a position to commit the fraud described in this complaint, and to fraudulently and unlawfully hypothecate, negotiate and transfer said stock, all to the damage of the plaintiff in the sum of $156,728.

FORTY-SECOND: That plaintiff was free from any negligence contributing to his aforesaid damage.

AS AND FOR A SIXTH CAUSE OF ACTION AGAINST THE DEFENDANT BANKERS TRUST COMPANY

FORTY-THIRD: Plaintiff repeats, reiterates and realleges each and every allegation contained in paragraphs of the

complaint designated "FIRST" through "FOURTEENTH" inclusive, with the same force and effect as if more fully set forth herein at length.

FORTY-FOURTH: That the defendant "Bankers", anxious to receive from defendants "Kates" the repayment of its loan foisted off upon the plaintiff the worthless 40,384 shares of restricted "National" stock, which it had held as collateral from "Kates" to secure said loan, and wrongfully and fraudulently concealed from plaintiff and "Arnold" that the collateral was restricted and limited as to its negotiability, assignability and transfer, and was substantially worthless.

FORTY-FIFTH: That further practicing such fraudulent concealment, the defendant "Bankers" its agents, servants and employees at the closing of the transaction silently and without disclosure permitted and allowed the defendants "Kates" to deliver an affidavit to the defendant "Arnold", to the effect that the aforesaid stock certificates were free and clear of any restrictions or limitations on negotiability, transfer or assignment.

FORTY-SIXTH: That continuing to practice said fraudulent concealment the said defendant "Bankers" its agents, servants and employees made no effort to inform the defendant "Arnold" of the falsity of said statement of the defendants "Kates" but on the contrary aided, abetted him and consented to such deception by remaining silent, despite its prior knowledge and notice that the aforesaid representations of "Kates" were false and fraudulent and that the monies of the plaintiff were to be paid over in reliance thereon.

FORTY-SEVENTH: That in further pursuance of such fraudulent concealment, the defendant "Bankers" at such closing accepted the plaintiff's monies in liquidation and repayment of "Kates" loan from the defendant "Bankers",

although its officers and agents then were aware that such monies were being advanced against worthless stock of "National", all to the damage of the plaintiff in the sum of $156,728. with interest from the 3rd day of March, 1972.

WHEREFORE, plaintiff demands judgment against the defendants in the sum of $156,728. with interest from the 3rd day of March, 1972, together with the costs and disbursements of the within action.

RUBEN SCHWARTZ
ABRAHAM EPSTEIN, of counsel
Attorneys for Plaintiff
450 7th Avenue
New York 1, N.Y.

VERIFICATION.

STATE OF NEW YORK, COUNTY OF NEW YORK: ss.

SAMUEL MALLIS being duly sworn, deposes and says that he is the plaintiff in the within action; that he has read the foregoing complaint and knows the contents thereof; that the same is true to his own knowledge, except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true.

SAMUEL MALLIS

Sworn to before me this
6 day of December, 1972.

BERNARD S. EPSTEIN
Notary Public State of New York
No. 31-6194075
Qualified in New York County
Commission Expires March 30, 1977

Affidavit of Abraham Epstein in Opposition to Motion to Dismiss Complaint.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

ABRAHAM EPSTEIN, being duly sworn, deposes and says:

1. I am trial counsel for the plaintiff herein and make this affidavit in opposition to the motions of the defendants Bankers Trust Company, referred to in the complaint as "Bankers" and William London referred to as "London", to dismiss the complaint for insufficiency pursuant to CPLR 3211(a)(7).

2. The recitations as to the facts are made by me upon information and belief, the source of my information and the grounds of my belief being accounts of investigations conducted by the office of the attorney of record for plaintiff, which are in the file turned over to me, correspondence and interviews with the plaintiff, who resides in a County other than where I maintain my office.

3. Since plaintiff personally had no contact with the knowing defendants he would, of necessity, be compelled to rely on the documents described above, if he were to make this affidavit, and it is for that reason that same has been dispensed with and mine substituted.

THE INCEPTION OF THE SCHEME

4. The plaintiff is a practicing dentist, residing in the County of Nassau; that the defendant Jack J. Arnold was a practicing attorney in Manhattan and had been acting in such professional capacity for plaintiff, in an unrelated matter.

5. The defendant John B. Fowler, Jr. was also a client of defendant Arnold, was represented to be a stockbroker, an executive and agent of J. S. Love & Co.

6. Sometime prior to the 3rd day of March, 1972, defendant Arnold approached plaintiff with a plan whereby plaintiff could earn $50,000.00 for a short term investment of capital.

Briefly stated, plaintiff was to advance towards the purchase price of 40,384 shares of Equity National common stock from Kates, the sum of $156,728.00, $25,000.00 having been previously paid by Fowler and Arnold.

The shares were to be held as collateral by plaintiff for thirty days at which time he was to receive the amount of his "investment" plus the sum of $50,000.00 "profit".

The terms of this agreement were embodied in a letter prepared by Arnold, annexed as plaintiffs Exhibit 1.

At the same time, there was exhibited to plaintiff a certain purchase agreement between Kates and Jack Arnold "as attorney", dated February 24, 1972, which had been prepared by the defendant London as Kates' attorney, for the sale of the stock to Arnold. There was no mention made of the stock being escrowed or otherwise restricted. A copy is hereto annexed as plaintiff's Exhibit 2.

Simultaneously, as additional bait, there was exhibited to plaintiff's the so-called "Option Contract", plaintiff's Exhibit 3 annexed, purporting to give Jack Arnold "as attorney", an option to purchase 110,000 shares of Merck & Co. Inc. common stock from Kates at sixty per cent of the then existing market price, stock which it developed later, Kates had never even owned.

THE CLOSING

7. On March 3, 1972, a closing of the stock transaction was had at the offices of Bankers Trust Co. Plaintiff was not present at the closing, having been assured by Arnold that he could handle it alone. On behalf of Bankers Trust Company was present the bank officer, Jack Jasper, and the bank attorney, Nathan Silverman.

The reason for their presence was that Kates owed the Bank a balance of $45,000.00 of a $50,000.00 loan, which he had not paid when due, but was liquidating on a monthly basis. The loan was secured only by the shares of Equity National stock in question, which bore in bold print on their face a legend indicating their non-negotiability and that they were subject to an escrow agreement.

Arnold purported to act for the plaintiff as attorney. Kates was present alone, his attorney, London, having absented himself. The money was brought to the closing by a representative of Franklin National Bank, from whom it had been borrowed by plaintiff.

When the stock certificates were finally prooduced (plaintiff's Exhibits 4 and 5), Arnold took from Kates and Kates delivered to him, an affidavit (Exh. 6) brazenly swearing that the legend on the stock was meaningless, and that the stock was free from any encumbrance. Arnold's motives in accepting so flimsy a contrivance are highly questionable. He certainly could not have been acting in the interests of plaintiff. He had apparently decided that no obstacle to the closing of the deal should be interposed.

Plaintiff's $156,728.00 was divided up between Kates and Bankers Trust Company, who were thus "bailed out" of a loan collateralized by worthless stock and even less reliable debtor.

The bank with its investigative facilities certainly had notice and knowledge of the restrictions on the stock. The making of the loan itself, based on such flimsy collateral, was not good sound banking practice, let alone the character of the borrower.

For the bank to stand by while the fraudulent affidavit was prepared by Kates and accepted by Arnold, in the absence of the plaintiff advancing the money, was something far more significant than mere silence of a bystander.

The closing was in its office, under its auspices and the atmosphere was conducive to an aura of respectability and reliability.

Instead of crying out indignantly at the perpetration of the outrage, the bank elected to participate in the spoils thereof, and "bail out" of its bad loan.

8. The attorney, London, had been an associate of the law firm which had represented Kates, when Equity National acquired his stock in Equity-Take Two Inc., and had issued the escrowed stock in partial consideration thereof.

Despite the knowledge which he must have acquired in such capacity as to the nature of the restrictions thereon, in preparing the purchase agreement (plaintiff's Exhibit 2) on behalf of Kates, who was now his client, he pointedly omitted to mention therein any encumbrances or lack of them. Couple this fact with his significant absence from the closing, where he knew the question would arise, and more than a fair case is made out of "fraudulent concealment".

Such an inference is buttressed by the fact that he subsequently again acted as attorney for Kates when restitution of the sum of $50,000.00 was made on account.

9. The incredible claims of the defendants Bankers and London to the effect that they were not obliged to speak, and that they could with impunity stand by, and watch must surely be made with tongue in cheek. The circumstances whereby plaintiff was mulcted of a small fortune by the perjurious affidavit of Kates (Exhibit 6), condoned and accepted by the attorney "Arnold" purportedly acting on behalf of the absent plaintiff, constituted an outrageous windle. To argue that "Bankers" a banking institution licensed as such by the State of New York and that "London", a member of the Bar, had no duty to speak under those circumstances, is simply not a valid argument. Especially is this so, when defendants' first-hand knowledge of the brazen hoax that was being perpetrated is reflected upon. If there was no duty upon them to break their silence, there was at least a solemn obligation on their part not to participate in fraudulent concealment. By their acts and their silence, they created an impression of truth. They were guilty of more than mere forbearance to speak. Each of them in their own self interest, had a motive for the concealment practiced upon the plaintiff.

The complaint spells out a good and meritorious cause of action. Conspirators do not publicly announce their intent to defraud. In order to establish the allegations of the complaint, it is vital that disclosure proceedings take place, including examination before trial of each of the defendants and inspection of the documents and papers in their possession.

The plaintiff here who has been cheated out of a substantial sum of money is entitled to his day in Court in order to establish the merits of his action.

WHEREFORE, it is respectfully prayed that the within motions be denied in all respects.

ABRAHAM EPSTEIN

(Sworn to April 27, 1973.)

Option Contract Between Jerome B. Kates and Jack Arnold, Dated February 24, 1972.

OPTION CONTRACT

THIS AGREEMENT made this 24th day of February, 1972 between JEROME B. KATES, as custodian for Michael Harlan Kates of the first part, and JACK ARNOLD, as Attorney of the second part,

WITNESSETH:

That in consideration of $1.00 in hand paid by said second party to first party, the receipt of which is hereby acknowledged, said first party hereby bargains, sells and grants to second party the option and right for the term of one (1) month from date, to purchase from first party the following property:

110,000 shares of common stock of Merck & Co., Inc. at sixty (60%) percent of the then existing market price to be determined by computing the preceding five day average closing price.

The delivery of the Merck & Co., Inc. shares shall be validly and properly issued and good title with no encumbrances of any nature except for Securities and Exchange Commission rules or regulations.

WITNESS our hand and seals at New York, New York this 24th day of February, 1972.

JEROME B. KATES
as Custodian

Option Contract Between Jerome B. Kates and Jack Arnold, Dated February 24, 1972.

INDIVIDUAL ACKNOWLEDGMENT

STATE OF NEW YORK, COUNTY OF NEW YORK, SS.:

Before me the undersigned, a Notary Public, in and for said County and State, on this 24th day of February, 1972, personally appeared JEROME B. KATES to me known to be the identical person who executed the within and foregoing instrument and acknowledged to me that he executed the same as his free and voluntary act and deed for the uses and purposes therein set forth.

Given under my hand and seal the day and year last above written.

My commission expires March 30, 1972.

M. E. SILFEN
Notary Public

MARTIN ELLIOTT SILFEN

Affidavit of Jerome B. Kates, Sworn to March 3, 1972.

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

JEROME B. KATES, being duly sworn, deposes and says:

That he is the owner of 29,821 shares of Equity National Industries, Inc. and that Judith Kates, his wife, is the owner of 10,563 shares of Equity National Industries, Inc., over which Jerome B. Kates has a written Power of Attorney to act.

On the back of each of these two (2) Certificates is a printed legend which reads as follows:

"The shares evidenced by this certificate are subject to the provisions of an Escrow Agreement dated August 7, 1970 among the Corporation, Equity-Take Two, Inc., The National Bank of Georgia and Stanley C. Lesser, as nominee for the former shareholders of Take Two, Inc., and may not be sold, transferred, pledged or hypothecated except in accordance with such Escrow Agreement, a copy of which may be examined at the office of the Corporation."

Deponent alleges that the legend on the back of each of these Certificates reflecting an Escrow Agreement, which is not present nor available to be attached to these Certificates, does in no way restrict the good transfer or negotiability of the shares.

That the particular shares involved have been released from the Escrow Agreement and will in no way encumber the negotiability of the same.

JEROME B. KATES
JEROME B. KATES

(Sworn to on March 3, 1972.)

Reply Affidavit of Nathan Silverman in Support of Motion to Dismiss Complaint.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

[SAME TITLE]

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

NATHAN SILVERMAN, being duly sworn, deposes and says:

That I am an attorney at law associated with Charles Leeds, the attorney for the defendant, Bankers Trust Company.

That I submit this affidavit in reply to the affidavit of Abraham Epstein, in opposition to the motion of the defendant, Bankers Trust Company, to dismiss the Complaint and for Summary Judgment.

In the first place, I cannot understand why Mr. Epstein submits his own affidavit instead of an affidavit by plaintiff. The Plaintiff resides in Nassau County; I see no reason for his failure to submit an affidavit. He was the person who negotiated the transactions in question. I can only suggest that the plaintiff, a sophisticated practicing dentist, is afraid to swear to an affidavit and tell the Court that all of the above named defendants duped and cheated him. Is this the naive innocent dentist who was represented by his attorney, Arnold, one of the above named defendants, who was interested in purchasing the Equity National Industries, Inc. stock at less than one-third (⅓) of the market value (Paragraph 11 of deponent's affidavit in support of this motion), and was also given an option to purchase Merck stock at 60% of its market value?

Mr. Epstein in Paragraph 7 of his affidavit, is very much mistaken in his statement that the Bank officer, Jack Jasper, was present at the closing. Your deponent was the only one present on behalf of Bankers Trust Company.

From a reading of the statements made by Mr. Epstein, it must be crystal clear to the Court that the plaintiff's grievance and quarrel is with his own attorney, the defendant Arnold, being sued for malpractice in this action. The opposing affidavit is replete with charges against the defendant Arnold.

In my Memorandum of Law submitted in support of the motion of the defendant, Bankers Trust Company, to dismiss the Complaint, I cited authority to the effect that since there was no confidential or fiduciary relationship between plaintiff and defendant, Bankers Trust Company, the Bank could not be liable for "silent acquiescence." Apparently, plaintiff's attorney, Epstein, realizes the weakness of his case and is now stressing "fraudulent concealment," and shying away from "silent acquiescence."

How can there be fraudulent concealment of legended stock which legend boldly appears on the stock certificates (plaintiff's own Exhibits 4 and 5)? How can there be fraudulent concealment when in truth and in fact, as plaintiff's own attorney states in his opposing affidavit that "Arnold took from Kates and Kates delivered to him an affidavit" (Exhibit 6 of his affidavit), concerning the restrictions of the legended stock. Again, plaintiff takes his own attorney to task.

At the bottom of Page 3 of the opposing affidavit, Mr. Epstein questions the wisdom of Bankers Trust Company in accepting as collateral security the Equity National stock to cover a loan made to defendant Kates. Who is plaintiff and his attorney to question the sound or unsound banking practice of an officer of Bankers Trust Company? Mr. Jasper, the Bank officer, is only answerable to his

superior and the Bank is answerable to the New York State Bank examiners. Be that as it may, Mr. Jasper stated in his affidavit in support of this motion, that he obtained an opinion from a reputable law firm concerning the restrictions and conditions attached to the Equity National Industries stock.

Mr. Epstein further deplores locale of the closing which took place at the office of counsel for Bankers Trust Company, and ascribes an ulterior motive to a closing in a dignified law office. Would Mr. Epstein have preferred that the closing took place in a "dark alley" so that he might have something to hang his hat on, namely, that it was so dark that the legend appearing on the stock certificates could not be seen by plaintiff's representatives? Your deponent makes this argument not facetiously, but as an indication of how far Mr. Epstein will stretch the rubber band to attempt to hold Bankers Trust Company in the case together with the seven (7) other defendants that plaintiff is suing.

In a desperate plea for denial of the motion of Bankers Trust Company to dismiss the Complaint, Mr. Epstein requests that disclosure proceedings take place. I am sure the Court will not heed such a plea because not one scintilla of evidence can be adduced, as is not already disclosed in the motion papers, and in the documentation submitted by both parties as Exhibits.

For the foregoing reasons, I again urge that the motion of the defendant, Bankers Trust Company to dismiss plaintiff's Complaint be in all respects granted.

NATHAN SILVERMAN
NATHAN SILVERMAN

(Sworn to on May 10, 1973.)

Opinion of Nadel, J., Dated July 13, 1972.

SUPREME COURT : NEW YORK COUNTY

[SAME TITLE]

NADEL, J.:

The three separate motions for dismissal of the complaint brought at various times by defendants, Equity National Industries, Bankers Trust Company and William London are consolidated for the purpose of this disposition.

Plaintiff, a dentist, entered into an arrangement with his own lawyer, defendant Arnold, whereby he advanced the sum of $156,728 for one month, and was to receive a "profit" of $50,000.00. As collateral for this loan, plaintiff was to hold 40,384 shares of Equity National Industries, Inc. There is absolutely nothing in the letter from defendant Arnold and defendant Fowler, whose status in this transaction is otherwise undefined, to indicate from whom the Equity shares would be obtained. Plaintiff received $50,000.00. He did not even attend the closing where his funds were transmitted by an officer of Franklin National Bank.

The Equity shares were restricted. The two stock certificates bore a legend to that effect on their face, and on the reverse side spelled out an Escrow Agreement held by the National Bank of Georgia. Arnold asked for and received an affidavit from defendant Kates to the effect that the restrictive legend had no force and effect. The shares were held by defendant Bankers Trust Company as collateral for a loan it had made to defendant Kates. The closing took place at Bankers Trust. Plaintiff thereafter found the stock to be without value and brought this action in conspiracy and fraud against all parties having any connection whatever with the shares or the transaction.

Defendant London, who was Kates' counsel, drafted an agreement between Kates and Arnold, and had no knowledge as to the existence of plaintiff. Moreover, he did not attend the closing. Plaintiff alleges he was guilty of silence when he had a duty to speak, which amounted to a "fraudulent concealment" because he knew of the Escrow Agreement and did not inform plaintiff.

Bankers Trust is likewise charged with the same duty to speak for the protection of plaintiff Equity National Industries, Inc., and is charged with both fraud and negligence in permitting "escrowed stock" into the possession of defendant Kates, thereby allegedly aiding and abetting in the swindle.

Plaintiff is proceeding under several fallacies with respect to facts. The Escrow Agreement sets up two classes of shares, conditional shares which were issued to the stockholders of the company being acquired subject to recall if certain profits were not realized, and final shares, which were held by the escrow agent until the number of final shares to be exchanged for conditional shares could be determined. The conditional shares had a restrictive legend placed on both face and back of each certificate. The restriction did not per se make the stock "worthless" as plaintiff contends. Equity National did not allow "escrowed shares" to circulate. These were final shares under the terms of the Escrow Agreement, which plaintiff could have determined from the National Bank of Georgia, the escrow agent, as well as transfer agent, if he had taken the precaution of examining the stock certificates.

The leading case on where there is a duty to speak is *Amend* v. *Hurley*, 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with de-

fendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this "investment", the Equity shares are called "collateral" and he is guaranteed *repayment* out of another stock transaction.

The "fraudulent concealment" he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend.

The motions to dismiss by these three defendants are granted. Settle orders.

s/ J. NADEL
J.S.C.

Dated: July 13, 1972

Order of Dismissal Entered August 1, 1973 by Nadel, J.

At an I.C. Trial Part 8 of the Supreme Court of the State of New York, held in and for the County of New York at the Courthouse located at 60 Centre Street, in the Borough of Manhattan, City of New York, on the 1 day of August, 1973.

Present: HON. BERNARD NADEL, Justice.

[SAME TITLE]

ORDER DISMISSING CAUSE OF ACTION

The defendant, Bankers Trust Company, by its attorneys, Charles Leeds, having duly moved for a Judgment pursuant to CPLR 3211(a) (7) dismissing the Complaint in the above entitled action, upon the ground that the Complaint fails to state a cause of action, and said motion having regularly come on to be heard,

Now, upon reading and filing the notice of motion dated February 20, 1973, the affidavit of Nathan Silverman sworn to January 12, 1973, the affidavit of Jack Jasper sworn to January 12, 1973 with the exhibits attached thereto, the reply affidavit of Nathan Silverman sworn to May 10, 1973, in support of the motion, the Summons and Complaint heretofore served herein, and upon the affidavit of Abraham Epstein sworn to April 27, 1973, in opposition thereto, and after hearing Nathan Silverman, Esq., of counsel for the defendant, Bankers Trust Company in support of said motion, and Abraham Epstein, Esq., of counsel for the plaintiff, in opposition thereto, and after due deliberation having been held thereon, and upon filing the opinion of the Court,

Order of Dismissal Entered August 1, 1973 by Nadel, J.

Now, upon motion of Charles Leeds, Esq., attorney for the defendant, Bankers Trust Company, it is

ORDERED, that the motion be and the same is hereby in all respects granted, and that Judgment be entered herein dismissing the Complaint in the above entitled action, as against the defendant, Bankers Trust Company, with costs as taxed by the Clerk of this Court and that the action against Bankers Trust Company be severed.

Enter,

s/ B N
J.S.C.

FILED

August 1, 1973

New York
County Clerks Office

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

LETTERHEAD OF HAUSER & ROSENBAUM, P.C.

May 6, 1975

Honorable Milton Pollack,
United States District Judge
United States Courthouse
Foley Square
New York, New York

Re: Mallis v. Federal Deposit Ins. Co., et al.
75 Civ. 909

Honorable Sir:

Yesterday we submitted to the Court a Memorandum of Law demonstrating the viability of the claims of the plaintiffs against each of the defendants. At Page 16 of that Memorandum, reference is made to a conversation had between the undersigned and an attorney who represented Equity National Industries prior to March 2, 1972, when plaintiffs became interested in the acquisition of stock, which is the subject of this action.

I have today received from that attorney, E. Cooke Rand, copies of documents and correspondence between Bankers Trust Company and the issuer, Equity National Industries, Inc., which are herewith enclosed. These documents are self-explanatory. In addition, I understand that Equity National Industries commenced an action in this Court against Jerome Kates and Bankers Trust Company under Docket No. 72 Civ.503, seeking cancellation of the securities. That action was abandoned in favor of a subsequently commenced action in the Delaware Courts.

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

Copies of this letter and enclosures are being forwarded to counsel for all parties.

Respectfully yours,

Noel W. Hauser

NWH:SL
cc: Hughes Hubbard & Reed, Esqs.
1 Wall St., New York, N.Y.
Charles Leeds, Esq.
1775 Broadway, New York, N.Y.

Sullivan & Cromwell, Esqs.
48 Wall St., New York, N.Y.

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

[EMBLEM] EQUITY NATIONAL INDUSTRIES

March 1, 1971

Bankers Trust Company
85 Delancey Street
New York, New York 10002

Attention Mr. Jasper

Re: Take Two, Inc.

Gentlemen:

This is to advise you that Take Two, Inc. ("Take Two") had no "net before tax earnings" for the calendar year 1970 and, accordingly, all shares of the common stock of Equity National Industries, Inc. ("Equity") issued to the former shareholders of Take Two are to be returned to Equity pursuant to the provisions of the Plan and Agreement of Merger between Take Two and the subsidiary of Equity into which Take Two was merged and the Escrow Agreement relating thereto. The certificates evidencing these shares bear a legend to the effect that they are subject to the provisions of this Escrow Agreement.

You are hereby requested to deliver to Equity at the address shown hereon all certificates for shares of common stock of Equity issued to Jerome B. Kates or Judith Kates in connection with the above merger of which you now have possession.

Should you have any questions, kindly contact the undersigned or our attorney, G. William Speer, at Powell, Goldstein, Frazer & Murphy, 1100 The Citizens and Southern National Bank Bldg., Atlanta, Georgia.

Very truly yours,

EQUITY NATIONAL INDUSTRIES, INC.

By: Arwin W. Strehlow, Vice President

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

March 4, 1971

Bankers Trust Company
85 Delancey Street
New York, New York 10002

Attention Mr. Jasper

Gentlemen:

In accordance with your request, enclosed herewith are copies of the following documents which bear upon the shares of common stock of Equity National Industries, Inc. given to you by Jerome B. Kates and Judith Kates to secure a loan or loans made by you to Mr. Kates.

1. Plan and Agreement of Merger between Equity-Take Two, Inc., a Georgia corporation and wholly-owned subsidiary of Equity National Industries, Inc., and Take Two, Inc., a New York corporation;

2. Escrow Agreement among Equity National Industries, Inc., Equity-Take Two, Inc., Stanley C. Lesser and The National Bank of Georgia; and

3. An amendment to the aforesaid Escrow Agreement.

We hereby renew our request on behalf of our client, Equity National Industries, Inc., that you return the above-mentioned shares. You will note from the enclosed documents that they were conditionally delivered to Mr. and Mrs. Kates as former shareholders of Take Two, Inc. and that they are no longer entitled to them.

Very truly yours,

G. William Speer
For Powell, Goldstein, Frazer & Murphy

GWS:cbi
Enclosures
cc: Mr. Arwin W. Strehlow

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

Letterhead of
Powell, Goldstein, Frazer & Murphy
Attorneys
Atlanta, Georgia 30303

April 14, 1971

Certified—Return
Receipt Requested

Bankers Trust Company
85 Delancey Street
New York, New York 10002

Attention: Mr. Jasper

Re: Take Two, Inc. and
Jerome and Judith Kates

Gentlemen:

By letter dated March 1, 1971, our client, Equity National Industries, Inc., requested that you deliver to Equity all certificates for shares of common stock of Equity issued to Jerome B. Kates or Judith Kates in connection with the merger of Take Two, Inc., a New York corporation, with Take Two, Inc., a Georgia corporation, a subsidiary of Equity. On March 2, 1971, my partner, William Speer and I met with your Mr. Masper to discuss the Take Two—Kates matter. We delivered to him at that time the March 1, 1971 letter referred to above.

At the request of your Mr. Jasper, we forwarded under cover letter of March 4, 1971, the documents which reflect the right of Equity to receive back the shares of stock issued to Mr. or Mrs. Kates.

We understood from our conversation with your Mr. Jasper that we would have some prompt indication

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

whether you would be willing to voluntarily deliver these certificates to our client. We have had no response to either of the two letters referred to.

We hereby demand immediate delivery to us or our client of Equity National Industries, Inc. Stock Certificates Nos. U1828 and U1833.

Please let us know if you intend to burden our client with the trouble and expense of filing legal action against the bank to obtain these certificates.

Thank you very much.

Yours truly,

Larry I. Bogart

LIB/h

cc: Managing Officer
Bankers Trust Company
85 Delancey Street
New York, New York 10002

Mr. Arwin Strehlow
Equity National Industries, Inc.
2700 National Bank of Georgia Building
Atlanta, Georgia 30303

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

[EMBLEM] BANKERS TRUST COMPANY
85 Delancey Street, New York, N. Y. 10002

JACK JASPER, Assistant Treasurer
Telephone 212 692-6863

April 20, 1971

Mr. Larry I. Bogart
Powell, Goldstein, Frazer & Murphy, Attorneys
Eleventh Floor
The Citizens & Southern National Bank Bldg.
Atlanta, Georgia 30303

RE: TAKE TWO, INC. AND
JEROME AND JUDITH KATES

Dear Mr. Bogart:

This is with reference to your letter of April 14th. Please be advised that we have made several appointments with Mr. Jerome B. Kates to meet with our Counsel and he has failed to keep such appointments. Our Attorneys are reviewing the papers in the files to the end that an opinion will be rendered as to the position of the bank with respect to the relationship of stock requested by you.

We ask your indulgence for a short time for proper evaluation to be made, at which time we will contact you and respond to your demand.

Very truly yours,

J. JASPER

JJ:IG

Letter of Noel Hauser to Judge Pollack with Enclosures, Dated May 6, 1975.

April 26, 1971

Mr. Jack Jasper
Assistant Treasurer
Bankers Trust Company
85 Delancey Street
New York, New York 10002

Re: Take Two, Inc. and
Jerome and Judith Kates

Dear Mr. Jasper:

Thank you for your letter of April 20th.

We would, of course, be happy to extend to the bank additional time for evaluation of your position by your attorneys.

Yours truly,

Larry I. Bogart

LIB/h

cc: Mr. Arwin Strehlow

Affidavit of Nathan Silverman, Sworn to May 12, 1975.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SAMUEL MALLIS and FRANKLYN KUPFERMAN,
Plaintiffs,

—against—

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,
Defendants.

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

NATHAN SILVERMAN, being duly sworn, deposes and says:

That I am an Attorney at Law associated with Charles Leeds, the Attorney for the Defendant, Bankers Trust Company.

That I am fully familiar with the facts and proceedings had and taken herein and all the proceedings in the State Supreme Court wherein Plaintiff, Mallis, in this action sued the Defendant, Bankers Trust Company.

That I submit this Affidavit in answer to the Plaintiff's Memorandum of Law.

While Judge Pollack directed Plaintiff's counsel to file a memorandum showing the alleged liability of each of the Defendants, the memorandum submitted is replete with statements of fact made by counsel of which he has no personal knowledge, based upon hearsay, speculation and wishful thinking. Apparently, counsel is using the vehicle of a Memorandum of Law to buttress an otherwise spurious claim against Bankers Trust Company; I cannot let this

tactic go unchallenged. I am sure that the Court will admonish Plaintiff's counsel with respect to his conduct in so doing.

To demonstrate the untruthfulness and misstatements made by Plaintiff's counsel, let me point out the facts to the Court, inter alia, the following:

1. On Page 3, counsel states that Kates pledged with Bankers Trust the securities involved for a loan of approximately $40,000.00. The truth of the matter is that the loan was made in 1970 for the sum of $50,000.00

2. On Page 9, Plaintiff's counsel would have the Court believe that Bankers Trust accepted the subject securities from Kates as collateral for the payment on a Judgment of $54,795.25 entered against Kates on July 20, 1971. The truth of the matter is that the securities pledged with Bankers Trust were pledged by Kates in August 1970 when the original loans were made to him. The Judgment entered as aforesaid against Kates was based on a Confession of Judgment which Kates and his wife signed and a "work out" arrangement was made with them to give them an opportunity to liquidate their indebtedness, and at the same time secure the Bank by a lien on their residence property which had substantial equity. Plaintiff's counsel is brazen enough to tell Bankers Trust how to conduct its business when he now inquires as to why the securities were not sold to satisfy the Judgment.

3. At the bottom of Page 14 of his memorandum, Plaintiff's counsel states that Bankers Trust Company transferred the securities in question. Nothing is further from the truth. The truth of the matter is, and this cannot be questioned, when Bankers Trust received payment from Kates when the securities were sold by him to Dr. Mallis, Bankers Trust merely returned to Kates the pledged securities. This was the usual simultaneous transaction

as this Court can readily observe. No *transfer* was ever made by Bankers Trust Company. The Court's attention is directed to a check of Franklin National Bank dated March 3, 1972 in the sum of $45,000.00 payable to the order of Jerome B. Kates, which check is one of the checks submitted by Plaintiff as Exhibit B with his Memorandum of Law. This check was originally drawn by Mr. Murfitt of the Franklin National Bank to the order of Jerome B. Kates and Bankers Trust Company. I pointed out to Mr. Murfitt that Bankers Trust Company was not involved in any dealings between Kates and Franklin's customer, Dr. Mallis, and accordingly, I insisted that Bankers Trust Company as co-payee be stricken which was done and initialled by Mr. Murfitt, as this Court can readily observe; a copy of the said check is sub-joined.

773584

FRANKLIN NATIONAL BANK

DATE March 3rd 1972

$45,000 AND 00 CTS

TO THE ORDER OF Jerome B. Kates
J.M.
~~and~~
~~Bankers Trust Company~~

NON-NEGOTIABLE
JOHN MURFITT
AUTHORIZED SIGNATURE

||00773548|| |:0210|||0148|: 401|||00000 5||

The position of Bankers Trust Company is demonstrated in its answer and the defenses asserted in this action, and bears repetition:

A. Dr. Mallis, one of the Plaintiffs herein, brought suit in the State Supreme Court. The gravamen of his com-

plaint against Bankers Trust was that Bankers Trust was guilty of "silent acquiescence" in sitting by and allowing Kates to sell the securities to Mallis, knowing that the same were worthless. The State Court, on Bankers Trust's motion for Summary Judgment, dismissed Plaintiff's complaint against Bankers Trust *on the merits.* All of the papers and exhibits used on said motion are annexed hereto and marked as a single Exhibit, and made part hereof. Dr. Mallis, having lost in the State Supreme Court on the theory of "silent acquiescence", is now urging active participation on the part of Bankers Trust. There is only one conclusion to be drawn, namely, Mallis is "hoist on his own petard".

While Mallis in the State Court action sued everybody including his Attorney, Arnold (for malpractice), he failed to sue Franklin National Bank and its bank officer, Murfitt, against whom Plaintiff now asserts all kinds of misconduct. His failure to proceed against Franklin in the State Supreme Court raises serious questions as to the bone fides of his present claim against Franklin. However, this is a matter for Franklin to raise, but your deponent merely mentions it to show the reaching out and callousness on the part of Plaintiff.

B. Having been non-suited in the State Court, Plaintiff is now attempting to re-litigate issues that could have been litigated in the State Court. The cases are legion that Plaintiff is collaterally estopped, and the determination in the State Supreme Court is res judicata in this action.

See the following cases:

Commercial Bank vs. *Employer Ins. of Wausau,* 293 N.Y.S.2d 403; 57 Misc.2d 510, and
Federation vs. *Jarvis and Spitz, Inc.,* 230 N.Y.S. 2d 517; 35 Misc.2d 414.

Dr. Mallis has had his day in Court.

C. Plaintiff Mallis was a total stranger to Bankers Trust Company with respect to any transactions that he had with Kates; there was no privity of contract, no fiduciary or confidential relationship between Mallis and Bankers Trust, and therefore, Regulation "U" or any other regulations do not affect Bankers Trust Company insofar as Dr. Mallis is concerned. I might say that if Bankers Trust saw fit to accept from Kates as collateral, worthless securities for the repayment of loans made him in 1970, that was the concern of Bankers Trust Company and Dr. Mallis cannot latch on to violations, if any, on the part of Bankers Trust in accepting such securities from its customer, Kates.

On Page 16 of his brief, Plaintiff's counsel claims that he has been informed by an Attorney, whose name he does not mention, that Bankers Trust had notice prior to March 2, 1972 that Kates' securities were void. We have received a copy of a letter dated May 6, 1975 addressed to the Court by Plaintiff's counsel, enclosing copies of correspondence had between Equity National Industries, its Atlanta, Georgia Attorneys and Bankers Trust Company. These documents indicate a unilateral claim by the issuer, Equity National Industries, for the surrender by Bankers Trust to them of the securities held by Bankers Trust as collateral for loan made to Kates. Suffice it to say that Bankers Trust rejected such demand because the only person to whom Bankers Trust was obligated to return the stock was to its customer, Kates, upon payment of his outstanding indebtedness. The action by Equity against Bankers Trust instituted in this Court under the Docket No. 72 Civil 503 was abandoned and discontinued and no further action was ever taken by Equity National against Bankers Trust, from all of which the conclusion can be drawn that Equity was convinced that it had no cause of action against Bankers Trust. In any event, I do not see how this matter is germane to the issues in this case and counsel is merely cluttering up the record.

Affidavit of Nathan Silverman, Sworn to May 12, 1975.

At the top of Page 8 of his memorandum, Plaintiff's counsel, Mr. Hauser, states:

> "that it is believed that Silverman, in behalf of the Bankers Trust Company, orally assured Arnold that the certificates in question were no longer subject to an Escrow Agreement."

I vehemently deny that I gave such oral assurance to Arnold and resent the introduction of this accusation without supporting evidence. Again counsel is indulging in speculation and conjecture. If such an assurance or representation were made, then why did Dr. Mallis charge Bankers Trust Company with *"silent* acquiescence." As the filed papers in the State Supreme Court action will disclose, the offices of the Legal Department of Bankers Trust Company were used merely as a convenience to all parties for the closing and your deponent, as counsel for Bankers Trust Company sat silently by on the sidelines waiting for Kates and Arnold (Dr. Mallis' attorney) to conclude their negotiations and upon receipt by official check of Franklin National Bank of the sum of $45,000.00, the securities held by Bankers Trust Company were thereupon returned to Kates, who in turn delivered them to Arnold and Franklin National Bank for the account of Dr. Mallis.

The Court's attention is directed to the fact that the complaint herein is not verified, Plaintiff's memorandum is not verified and what counsel for Plaintiff seeks to do is to assert loose accusations, not supported by facts in an endeavor to conjure up some sort of cause of action in order to harass Bankers Trust Company. I feel confident that the Court will put an end to this harassment by dismissing Plaintiff's complaint against Bankers Trust Company. Plaintiff's request to re-plead should be denied as utterly lacking in merit.

/s/ Nathan Silverman

(Sworn to May 12, 1975.)

Affidavit of Samuel Mallis and Franklyn Kupferman, Sworn to May 14, 1975.

UNITED STATES DISTRICT COURT
Southern District of New York

[SAME TITLE]

State of New York }
County of Kings } ss.:

Samuel Mallis and Franklyn Kupferman, both being duly sworn, depose and say:

We are the plaintiffs in the within action. We submit this affidavit in opposition to the motion of European American Bank & Trust Company for dismissal of the Complaint herein.

We are both dentists practicing in Long Island. In approximately February of 1972, deponent Mallis had a conversation with one Jack Arnold, an attorney in the City of New York. Arnold told Mallis that he, in behalf of a client, one Fowler, an officer of J. S. Love & Co., a stock brokerage firm, had made a deposit toward the purchase of approximately 40,000 shares of the stock of Equity National Industries, Inc. Arnold told Mallis that the securities were unregistered, but that they would become marketable within a short period of time thereafter by reason of the promulgation of a new Rule promulgated by the Securities and Exchange Commission. Arnold told Mallis that the entire purchase price for the 40,000 shares was approximately $181,000.00 and that approximately $156,000.00 was urgently required to complete the purchase in default of which the deposit money would be forefeited and the benefit of the bargain would be lost. Arnold inquired of Mallis as to whether he or anybody in his circle

was in a position to provide the necessary funds to complete the transaction and offered an incentive a profit of $50,000.00 therefor. Arnold was able to justify the $50,000.00 increment because the market value on the American Stock Exchange of the stock of the issuer was between $10.00 and $13.00 per share, and the sale of the securities would produce funds at the then current price of at least $400,000.00.

Mallis had no such funds available. However, since Arnold had been representing Mallis in an unrelated transaction, Mallis agreed to make inquiries among his circle of friends and acquaintances to see whether the funds could be raised. Amongst others, Mallis called the plaintiff Kupferman, his brother-in-law. The funds could not be raised privately and accordingly Kupferman called John Murfitt, then an officer at the Franklin National Bank, for the purpose of inquiring as to whether the bank would be interested in participating in this transaction. Deponents at that time had no thought whatever of themselves becoming involved as principals.

Murfitt promptly returned Kupferman's communication to advise that he had checked out the transaction; that it appeared to be fair and regular; and that it represented a business opportunity which, however, the bank would not be willing to directly participate in, but would willingly advance all of the funds necessary to us in order that the transaction might be consummated.

The following day, March 3, 1972, we attended at the office of the Franklin National Bank, Uniondale Branch, prior to its official opening, as directed by Murfitt. We there signed documents which had been prepared by Murfitt. We were not requested to provide any collateral, nor did we in fact provide any collateral. Following execution of the documents, Murfitt advised us that it would be unnecessary for us to attend the closing scheduled for later that day because he himself would attend in our stead and disburse the bank funds. We thereupon left the bank and went to our respective offices.

In the latter part of the afternoon of the same day, Murfitt delivered the securities to the office of deponent Kupferman and stated that with the exception of the production of the Escrow Agreement to which the securities referred on their face, the transaction had been completed quite regularly.

Deponents first became concerned when we received the Escrow Agreement to which the certificates referred on their face. We then understood that the certificates had not been regularly issued in the first instance. We thereafter were in communication with various law enforcement agencies, but all to no avail.

We had been advised prior to the closing that the securities in question were in the hands of Bankers Trust Company. On the morning of the closing, Murfitt advised us that the securities were held by Bankers Trust Company as collateral for a loan to Jerome and Judith Kates, who were the owners thereof. At least one of the checks was to be drawn payable to the joint order of Jerome Kates and Bankers Trust Company. We subsequently learned that without our authority, the designation of Bankers Trust Company as a co-payee on that check had been stricken out at the time of closing.

We also subsequently learned that Bankers Trust Company had been placed upon direct notice by the issuer of the securities that the securities had not been regularly issued, but rather conditionally issued, and that they could not and should not be sold, transferred or hypothecated because they were worthless in that the conditions pursuant to which they had been issued had not been met. We

Affidavit of Samuel Mallis and Franklyn Kupferman, Sworn to May 14, 1975,

were also advised that at the very time of the closing, Kates and Bankers Trust Company had both been named as Parties-Defendants in an action pending in this Court under Index No. 72 Civ.503, and that the securities in question, amongst others of a similar issue, were the subject matter in issue.

We would not have become interested in this transaction if other securities of the issuer were not regularly being traded on the American Stock Exchange and if the then current price of the securities when regularly traded were not at least several times the amount of money which we had generated for use in consummating the transaction.

We are informed by our attorneys and believe that we have a good and meritorious cause of action (a) against the defendants Federal Deposit Insurance Corporation and European American Bank, as well as Franklin National Bank for cancellation and rescission of any obligations claimed by them to be owing by us, and (b) against Bankers Trust Company which withheld vitally material information from us and our representatives and, as we are informed, actually misrepresented that the securities in question were genuine when in fact they were not. We, therefore, respectfully pray that the motion for an order of dismissal be denied.

s/ Samuel Mallis

s/ Franklyn Kupferman

(Sworn to on May 14, 1975.)

Letter of Noel Hauser to Judge Pollack with Attachments, Dated May 15, 1975.

Letterhead of Hauser & Rosenbaum, P.C.

May 15, 1975

Honorable Milton Pollack,
United States District Judge
United States Courthouse
Foley Square
New York, New York

Re: Mallis, et al. v. Franklin National Bank, et al.
75 Civ. 909

Honorable Sir:

At a conference with the Court, the undersigned as the attorneys for plaintiffs, were directed to submit a memorandum demonstrating the viability of the claims of the plaintiffs against each of the defendants herein. We submitted such a memorandum which concededly did contain certain factual statements which were intended to comply with the Court's direction to submit a memorandum demonstrating the viability of the claims of the plaintiffs against each of the defendants.

Yesterday, we submitted an affidavit of the plaintiffs in opposition to the motion of the defendant European-American Bank to dismiss the Complaint, which motion was adjourned to May 16th, but which motion we understand has now been indefinitely postponed pending consideration by the Court of the position of the respective parties. Today we received an affidavit over the signature of Nathan Silverman, sworn to May 12, 1975, in behalf of Bankers Trust Company. The affidavit contains

both factual statements and a reference to legal authority. I beg leave of the Court to submit the instant letter and enclosures in connection with the Silverman affidavit

Firstly, the Court will observe that the motion of Bankers Trust Company dated February 20, 1973 addressed to the Supreme Court and seeking an Order of Dismissal of the Complaint as against Bankers Trust Company, was made under the authority of CPLR § 3211(a)(7) "on the ground that the said Complaint fails to state a cause of action as against the defendant Bankers Trust Company . . .".

The cases are legion that a dismissal based upon that ground is not on the merits unless the Order of Dismissal so provides, and a copy of the Order has not been submitted. CPLR § 5013 expressly so provides. The cases cited in the Silverman affidavit involve the defense of *res judicata* or collateral estoppel were raised after a trial on the merits which had resulted in each case in favor of the movant. Moreover, even if the disposition had been made on the merits, it is the position of plaintiffs that an action predicated on a violation of Rule 10b-5 is not precluded by an earlier State Court determination that common law fraud did not affect a securities transaction. This position is predicated on the proposition that § 27 of the Securities Exchange Act of 1934 grants exclusive jurisdiction to the Federal Courts to determine violations thereof, and consequently, an earlier State Court determination could not have involved a determination of liability under Rule 10b-5.

As to the factual allegations contained in the Silverman affidavit, I am submitting herewith portions of the transcript of the examination before trial of John B. Fowler, Jr., a defendant in the Supreme Court action, taken Sep-

tember 12, 1973, after the State Court had granted the motion to dismiss the Complaint. The Court can readily see that serious factual questions are presented.

Respectfully yours,

NOEL W. HAUSER
Noel W. Hauser

NWH:SL
encls.

cc: Sullivan & Cromwell, Esqs.
Attorneys for Deft. European-American Bank
48 Wall Street
New York, New York 10005

Hughes, Hubbard & Reed, Esqs.
Attys. for Defts. FDIC and FNB
One Wall Street
New York, New York

Charles Leeds, Esq.
Attorney for Bankers Trust Co.
1775 Broadway
New York, New York 10019

ATTACHMENT TO LETTER OF MAY 15, 1975

(21) Fowler, Junior—direct

A. Repeated the statement made by—
Q. Tell us what you said. A. That there were suits against Mr. Kates and that this stock was tied up in an escrow agreement.

Letter of Noel Hauser to Judge Pollack with Attachments, Dated May 15, 1975.

Q. Yes. A. And they assured me that it was not, that there was other stock in an escrow agreement, but not this stock, this had been freed from the escrow agreement.

Q. After you received that information from them what did you do about it? A. Well, I also talked to Mr. Silverman, who is the vice president of the Bankers Trust Company and said would you deliver.

Q. Was that Nathan Silverman, the general Counsel? A. Yes, that's the man, the man that was at the closing.

Q. What did he say? A. He assured me that they would deliver the stock.

Q. Did you ask him about the suits pending from Equity National against the Kates? A. He stated there was nothing involved, (22) that the stock was not involved.

Q. You mean Mr. Silverman told you that? A. The stock was not involved.

Q. Now, what else did you do, if anything, after you learned that there was a suit pending against Kates and against Bankers Trust, was it? A. No, there was no statement it was a suit at that time against Bankers Trust.

Q. Just against Kates? A. Just against Kates.

Q. Involving the stock. Did you do anything else to verify that Kates had a right to deliver the stock? A. No.

Q. You accepted the assurances? A. From Mr. Silverman.

Q. Mr. London? A. Mr. Kates and Mr. London, yes.

Q. You say Mr. Silverman assured you that Kates had a right to deliver stock? A. Yes, he did.

Q. And Mr. London assured you of that too? A. He did.

Q. Now, at these conversations where you got

Affidavit of Philip K. Howard in Support of Motion by European-American Bank and FDIC.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 909 (MP)

AFFIDAVIT

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs,

—against—

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and THE BANKERS TRUST COMPANY,

Defendants.

STATE OF NEW YORK
COUNTY OF NEW YORK } ss.:

Philip K. Howard, being duly sworn, deposes and says:

1. I am a member of the Bar of the State of New York and am associated with the firm of Sullivan & Cromwell, attorneys for European-American Bank & Trust Company (hereinafter "European-American"). I am familiar with the pleadings and proceedings heretofore had in this case. I submit this affidavit in support of the memorandum submitted by European-American and the Federal Deposit Insurance Corporation as receiver of Franklin National Bank; in particular, I submit this affidavit for the purpose of showing that the certificates in which plaintiffs

herein held an interest never represented securities that were listed on the American Stock Exchange.

2. Until recently, the common stock of Equity National Industries, Inc. was listed and traded on the American Stock Exchange. I obtained from the American Stock Exchange a copy of the listing application submitted by Equity National Industries, Inc. (attached hereto in part as Exhibit A). This application shows that 2,411,772 shares were originally listed and that 175,000 conditional shares, of which plaintiffs' certificates represented a portion, were not listed and would not be listed until "official notice of issuance".

3. In order to ascertain whether any or all of these 175,000 conditional shares were ever listed, on May 14, 1975 I reviewed the Equity National Industries, Inc. registration file with Mr. John Gaughran, the manager of the registration section of the American Stock Exchange. Mr. Gaughran said that in order to list such conditional shares, the issuer first must formally notify the American Stock Exchange that such additional shares should be listed. The Exchange would then prepare a "registration authorization" ticket which would indicate the number of additional shares to be registered. Upon payment to the Exchange of the listing fee for the additional shares, the shares would then be "listed".

4. The file indicated that none of the requisite steps for listing the 175,000 shares, or any part thereof, were ever taken; no notice was given, no listing fee was paid, and no "registration authorization" form was prepared. A "control card", showing the changes in the number of shares listed, omitted any reference to the conditional

shares and affirmatively indicated that these shares were never listed.

PHILIP K. HOWARD

Sworn to before me this
16th day of May, 1975

EILEEN L. FRANKLYN
Notary Public

EILEEN L. FRANKLYN
Notary Public, State of New York
No. 31-1303130
Qualified in New York County
Commission Expires March 30, 1977

Exhibit A Annexed to Affidavit of Philip K. Howard.

LISTING APPLICATION No. 8791 AMERICAN STOCK EXCHANGE

The listing application of Equity National Industries, Inc., which is set forth below was approved on October 15, 1970.

The papers and exhibits submitted by the Company in support of its application are available for inspection at the Library of the Exchange.

EQUITY NATIONAL INDUSTRIES, INC.

(Incorporated under the laws of the State of Delaware on February 9, 1968)

COMMON STOCK, $1 PAR VALUE
Cusip 294732 10 2

Atlanta, Georgia
October 8, 1970

ORIGINAL LISTING:

Equity National Industries, Inc. (the "Company") hereby makes application to the American Stock Exchange for the listing of:

2,411,772 issued and outstanding shares of its Common Stock, $1 par value per share ("Common Stock");

50,362 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of Cunningham Art Products, Inc., a Georgia corporation, acquired on August 28, 1968, if the earnings of the business formerly conducted by such company reach certain specified levels;

85,035 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of Hewett Studios, Inc., a Georgia corporation, acquired on October 28, 1968, if the earnings of the business formerly conducted by such company reach certain specified levels;

68,834 additional shares of its Common Stock upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of Water Bonnet, Inc., a Florida corporation, acquired on February 14, 1969, if the earnings of the business formerly conducted by such company reach certain specified levels;

139,058 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of A&U Mobile Homes of North Carolina, Inc., a North Carolina corporation; A&U Mobile Homes, Incorporated, a Virginia corporation; A&U Sales, Incorporated, a Virginia corporation; and A&U Homes Corporation, a Virginia corporation, acquired on December 22, 1969, if the earnings of the businesses formerly conducted by these companies reach certain specified levels;

225,881 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the

Company may be obligated to issue to former shareholders of Jordan Mills, Inc., a Georgia corporation, acquired on February 24, 1970, if the earnings of the business formerly conducted by such company reach certain specified levels;

12,000 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of Top Line, Inc., a Tennessee corporation, acquired on March 6, 1970, if the earnings of the business formerly conducted by such company reach certain specified levels;

9,000 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of Stain Glass Products, Inc., an Ohio corporation, acquired on September 12, 1969, if the earnings of the business formery conducted by such company reach certain specified levels;

400,000** additional shares of its Common Stock, upon official notice of issuance, which represent the number of shares which the Company may be obligated to issue to former shareholders of Marathon Finishers, Inc., a Georgia corporation, acquired on May 20, 1970, if the earnings of the business formerly

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** The exact number of shares which may be deliverable is presently not determinable and, accordingly, the number of shares reserved is an estimate made for purposes of the Listing Application.

conducted by such company reach certain specified levels;

150,000 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to former shareholders of Direct Carpets, Inc., a Georgia corporation. Direct Carpets, Inc., a Tennessee corporation, Mill End Wholesale, Inc., a Georgia corporation, Carpet Franchisers, Inc., a Georgia corporation, and Broadloom Carpets, Inc., a Georgia corporation, acquired on June 2[illegible], 1970, if the earnings of the business formerly conducted by Direct Carpets, Inc., a Georgia corporation, reach certain specified levels;

175,000 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to the former shareholders of Take Two, Inc., a New York corporation, acquired on August 7, 1970, if the earnings of the business formerly conducted by such company reach certain specified levels;

6,000 additional shares of its Common Stock, upon official notice of issuance, which represent the maximum number of shares which the Company may be obligated to issue to the former shareholders of Behamy & Company, Inc., and Casual Art Imports. Inc., both Georgia corporations, acquired on July 30, 1970, if the earnings of the businesses formerly conducted by such companies reach certain specified levels;

Exhibit A Annexed to Affidavit of Philip K. Howard.

50,000 additional shares of its Common Stock, upon official notice of issuance, upon exercise of stock warrants issued in connection with an 8% Senior 15-Year Note of the Company;

148,100** additional shares of its Common Stock, upon official notice of issuance, upon the conversion of an 8% Convertible Subordinated 15-Year Note of the Company;

12,000 additional shares of its Common Stock, upon official notice of issuance, upon exercise of Stock Warrants issued in connection with a Senior Term Note of the Company;

200,000 additional shares of its Common Stock, upon official notice of issuance, upon exercise of stock options granted or to be granted pursuant to the Company's Qualified Stock Option Plan;

50,000 additional shares of its Common Stock, upon official notice of issuance, upon exercise of stock options granted or to be granted pursuant to the Company's Qualified Stock Option Plan for Subsidiaries;

148,834 additional shares of its Common Stock, upon official notice of issuance, upon exercise of outstanding stock warrants;

2,240 additional shares of its Common Stock, upon official notice of issuance, upon exercise of outstanding nonqualified stock options; making a total of

4,344,116 shares of Common Stock, the listing of which is herein applied for (of a total authorized issue of 8,000,000 shares of Common Stock).

Exhibit A Annexed to Affidavit of Philip K. Howard.

All of the shares of Common Stock, the listing of which is herein applied for, are, or upon issuance and payment therefor will be, fully paid and nonassessable, with no personal liability attaching to the ownership thereof.

CAPITALIZATION

(September 30, 1970)

Class	*Authorized by Charter*	*Authorized for Issuance**	*Outstanding*	*Listing Applied For**
Preferred Stock, No Par Value	250,000	—	—	—
Common Stock, $1 Par Value	8,000,000	4,344,116	2,411,772	4,344,116

* Of the total shares of Common Stock authorized for issuance, 1,932,344 shares are unissued and reserved for issuance in the amounts and for the purposes set forth in the preceding section. There are no other unissued shares of Common Stock reserved for issuance for any purpose.

STOCKHOLDERS

As of June 30, 1970, there were 1,797 holders of record of the Company. No person is known by the Company to own, of record or beneficially, more than 10% of the Company's outstanding Common Stock.

As of June 30, 1970, the officers and directors of the Company, as a group (consisting of 10 persons), owned directly, indirectly or beneficially 351,542 shares of the Company's Common Stock, which represents 17% of the total outstanding shares of Common Stock.

Notice of Motion of Bankers Trust Company to Dismiss Complaint, Dated August 25, 1975 and Filed September 30, 1975.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

SIRS:

PLEASE TAKE NOTICE that upon the affidavit of Nathan Silverman, sworn to the 12th day of May 1975, the Reply Memorandum of Bankers Trust Company and Affirmation of Jack H. Weiner affirmed on the 8th day of August, 1975, and upon all of the pleadings, papers and proceedings heretofore served herein, the undersigned will move in this court before the Honorable Milton Pollack on the 25th day of August 1975 at 4:00 P.M. or as soon thereafter as counsel can be heard for an order pursuant to the Federal Rules of Civil Practice 12 (b) (6) dismissing Count III of the complaint as against Bankers Trust Company, upon the grounds that the pleading fails to state a claim upon which relief can be granted, that it further fails to provide jurisdiction in the United States District Court for such a claim against Bankers Trust Company and is barred by res judicata and collateral estoppel.

Dated: New York, New York
August 25, 1975

Yours, etc.,

CHARLES LEEDS

By LAWRENCE S. BERKOWITZ
Lawrence S. Berkowitz
A member of the Frm
Attorneys for Bankers Trust Company
1775 Broadway
New York, N.Y. 10019
(212) MU 2-5889

Letter of Noel W. Hauser to Judge Pollack, Dated August 29, 1975.

August 29, 1975

Honorable Milton Pollack
United States District Judge
United States Courthouse
Foley Square
New York, New York 10007

RE: Mallis, et ano v. Federal Deposit Insurance Corp., et al.
75 Civ. 909 (M.P.)

Dear Judge Pollack:

At the Conference before the Court on August 25, 1975, which was attended by counsel for all parties, Your Honor indicated a disposition to dismiss all counts of the Complaint because of the failure to state a Federal claim against any of the defendants. As the attorney for plaintiffs I have requested an additional period of time within which to submit further argument or documentation to support the existence of a Federal claim in favor of my clients, the plaintiffs. The Court indicated a willingness to accept and consider further writings on the subject.

As to the claim of the plaintiffs against Bankers Trust Company under the Anti-Fraud Provisions of the Federal Securities Laws, the Court indicated that its thinking was that the Complaint was defective because the plaintiffs were not either "purchasers" or "sellers" of the securities in question and that the decision by the United States Supreme Court two or three months ago in the Blue Chip case dictated that the Anti-Fraud Provisions of the Federal Securities Laws may be invoked only by such purchasers or sellers. As I indicated to the Court during the course of discussion, I believe that the Blue Chip case goes no further than to hold that a party who claims he

would have purchased stock, but did not do so because of a securities fraud, has no claim. The decision in the Blue Chip case discusses at length the difficulties of dealing with a non-actor who subjectively claims that he would have acted except for the fraud.

I respect the interpretation by the Court that the decision in the Blue Chip case mandates strict adherence to the so-called "Birnbaum" doctrine, but I would urge the Court to consider whether such strict adherence is indeed required, given the decision by the United States Supreme Court in *Superintendent of Insurance* v. *Banker's Life Insurance Co.*, et al., 404 U.S. 6 (1971). In that case, the owner of all of the stock of Manhattan Casualty Co. sold the same to a vendee which used the assets of the Manhattan Casualty Co. with which to pay the price of the stock to the seller. Neither the purchaser nor the seller, therefore, suffered injury. The injury was suffered by creditors of Manhattan Casualty Co. whose assets had thereby been depleted. In reversing the dismissal of the Complaint by the Second Circuit, the United States Supreme Court pointed out that the creditors of the party injured through a violation of the Anti-Fraud Securities Laws had a legitimate interest in seeking redress upon a showing of grevious injury. Assuming that the plaintiffs in the instant case are, strictly speaking, not "purchasers" of the securities in question, they certainly have suffered substantial damages and certainly an issue of fact is raised as to whether Bankers Trust Company was under a duty to disclose all of the facts at its disposal. In the cited case, the Superintendent of Insurance was acting as the surrogate of creditors of Manhattan Casualty Co. If the Court is nevertheless disposed to strictly adhere to the "Birnbaum" doctrine and to rule that the count as against Bankers Trust Company must be dismissed because plaintiffs are mere creditors of the actual purchasers, Fowler and Arnold, I would respectfully urge the Court to consider entertaining an application by plaintiffs, pursuant to Rule 19(a) and (b) of the Federals Rules of Civil Procedure for an order directing the joinder of Fowler and Arnold as involuntary parties plaintiff, or as defendants. The claims asserted by the plaintiffs in this case are not ephemeral or based upon subjective conditions; the damages suffered by them are real and I respectfully urge that dismissal of the count as against Banker's Trust Company, because plaintiffs are not, strictly speaking, "purchasers", would result in a miscarriage of justice, particularly so since as the papers before the Court demonstrate, the Supreme Court of the State of New York has dismissed the claim of the plaintiffs as against the Banker's Trust Company for failure to demonstrate the elements of a fraud case under State Law.

With respect to the claims of the plaintiffs as against the remaining defendants, we stand upon the arguments previously advanced.

Should the Court be inclined to entertain an application to join Fowler and Arnold as involuntary party plaintiffs or as necessary defendants, I would appreciate word from Chambers as to the foregoing effect and I would then proceed to the preparation of formal motion papers.

A copy of this letter is being forwarded to counsel for all the parties.

Respectfully yours,

Noel W. Hauser

NWH:jw

cc: Sullivan & Cromwell—European-American Bank
Hughes, Hubbard & Reed—Federal Deposit
Charles Leeds, Esq.—Bankers Trust Company

Decision of the District Court.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 909 (MP)

MEMORANDUM

#43153

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and THE BANKERS TRUST COMPANY,

Defendants.

APPEARANCES:

HAUSER & ROSENBAUM
Attorneys for Plaintiffs
350 Fifth Avenue
New York, N.Y. 10001
By: Noel W. Hauser, Esq.

HUGHES HUBBARD & REED
Attorneys for Defendant (Federal Deposit Insurance Corporation as Receiver of Franklin National Bank)
One Wall Street
New York, N.Y.
By: Robert S. Anderson, Esq.

Decision of the District Court.

SULLIVAN & CROMWELL
Attorneys for Defendant (European-American Bank & Trust Company)
48 Wall Street
New York, N.Y.
By: John L. Warden, Esq.

Charles Leeds, Esq.
Attorney for Defendant (Bankers Trust Company)
1775 Broadway, New York, N.Y. 10019
By: Nathan Silverman, Esq.

MILTON POLLACK, District Judge.

Federal Deposit Insurance Corporation (FDIC hereafter) and European American Bank (EA) are successors in interest to an insolvent, Franklin National Bank (FNB).

Plaintiffs, two dentists, borrowed $156,000 from FNB on March 3, 1972, and now claim that the loan (reduced substantially by repayments on account) violated Regulation U (Federal Reserve Regulations 12 CFR Section 221.1 et seq.) prohibiting loans secured by margin stock in an amount in excess of the prescribed maximum loan value of the stock. Plaintiffs contend in their first claim for relief that the loan was made for the purposes of carrying or acquiring margin stock and is therefore void and that it should be declared that they are not liable thereon.

Since the loan was neither directly nor indirectly made for the purpose of carrying or purchasing "margin stock" or being secured thereby nor were the arrangements with plaintiffs interposed as a subterfuge for avoidance of Regulation U by FNB, the first claim fails to state a claim on which federal relief may be granted.

Plaintiffs, Mallis and Kupferman, arranged the loan from FNB based solely on their signatures to a loan agreement. Their purpose was to take advantage of a busi-

ness opportunity which they hoped would yield them a $50,000 profit. The opportunity involved the loan by them of money to one Fowler and his attorney Arnold on the obligation to repay the same on certain conditions with a $50,000 bonus or profit for the accommodation. Fowler had made a deposit toward the purchase of 40,000 shares of Equity National Industries, Inc., and needed more funds in order to complete the purchase. The shares were held by Bankers Trust Company, a defendant herein, as collateral for a loan to the shares' owners, Jerome and Judith Kates, who were the sellers in the transaction with Fowler.

The shares were unregistered, but Arnold is alleged to have represented to Mallis that they would become marketable in the near future because of a new rule promulgated by the Securities Exchange Commission. The shares if marketable would have, according to plaintiffs, been worth at least $400,000.

In actuality, the shares were subject to a restriction that ultimately made them worthless. They had been issued to the Kates pursuant to the agreement by which a company called Take-Two, Inc. was merged into a subsidiary of Equity. The two certificates for the shares bore legends indicating that the shares had not been registered under the Securities Act and could not be transferred except in accordance with an escrow agreement to which they were subject. Under the escrow agreement, depending on whether specified earnings conditions for the prior business of Take-Two were met for specified years, the shares would be returned to Equity to be either cancelled or reissued without the restrictive legend referring to the escrow agreement.

By letter of March 1, 1971, Equity wrote to Bankers Trust, which held the shares as collateral on an August 1970 loan to the Kates, indicating that the earnings requirement had not been met for 1970 and requesting that the Equity shares issued to the Kates be delivered to

Equity in accordance with the escrow agreement. Bankers Trust declined to do so. Equity brought suit in New York to obtain a cancellation of the shares but the suit did not proceed to a judicial determination. Equity ultimately brought suit in Delaware state court in May 1974 to obtain or to void the certificates of stock, naming the plaintiffs, the Kates, and FNB as defendants, but not Bankers Trust. This suit also did not go to judgment. Plaintiffs allege that the shares are now worthless, and indeed were worthless at the time of the Mallis-Arnold-Kates agreement culminating in their sale. At the closing of the sale, the funds transferred to Kates as consideration for the stock were turned over to Bankers Trust in payment of the outstanding indebtedness of the Kates to Bankers Trust. Bankers Trust then released the stock. Plaintiffs took the shares as collateral for their loan to Arnold and Fowler and now hold them after default by those borrowers.

Plaintiffs, as noted *supra*, seek to cancel their own indebtedness to FNB and its successors by alleging that the loan to them was in violation of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221.1 *et seq.*, as having been secured by stock for the purpose of purchasing or carrying "margin stock" in an amount in excess of the prescribed maximum loan value of the collateral.

Plaintiffs' allegations on this point fall short of adequacy in at least two ways, even assuming *arguendo* that they have sufficiently alleged that the loans were secured by stock. *Cf. Freeman* v. *Marine Midland Bank-New York*, 494 F.2d 1334 (2d Cir. 1974). The shares in question here were not "margin stock" within the meaning of Regulation U, and there was no loan for the purpose of purchasing stock within the meaning of that regulation.

The only definitional category of margin stock which arguably applies to the certificates of Equity common stock

involved herein is that of stock "registered on a national securities exchange". It appears that listed shares of Equity common stock were in fact registered and traded on an exchange at the time of the transaction herein. However those shares here involved were neither registered nor listed on a national securities exchange.

EA and FDIC have introduced the listing application submitted to the American Stock Exchange by Equity for the listing of a number of categories of common stock including "175,000 additional shares of its common stock, *upon official notice of issuance*, which represent the maximum number of shares which the Company may be obligated to issue to the former shareholders of Take-Two, Inc. . . . if the earnings of the business formerly conducted by such company reach certain specified levels." (emphasis added) (Exhibit A to Howard affidavit, May 16, 1975).

In order for such shares to have been actually listed, Equity would have had to formally notify the Exchange that the conditions had been met, a "registration authorization" indicating the number of shares would have had to be prepared by the Exchange, and a listing fee would have had to be paid by Equity. A review of the American Stock Exchange file indicated that none of these steps had ever been taken, and that the shares were never listed, which is hardly surprising given Equity's efforts to have the shares returned to it. (*See* Howard affidavit, *supra*, ¶¶ 3 and 4).

Contrary to plaintiffs' assertions, shares of stock are not "registered" on a securities exchange within the meaning of Regulation U when they are not themselves listed merely because other shares of their class are listed. *See* Published Interpretations of the Board of Governors of the Federal Reserve System, ¶ 6440 (1971) (Regulation U not applicable to loan to purchase newly issued stock during initial over the counter trading period prior to the stock "becoming registered (listed) on a national securities

exchange"). The opinion letter of an attorney for the Board of Governors submitted to this Court by the plaintiffs is not dispositive here since the question the attorney was answering is not on point with the issue in contention. Since the Equity shares purchased from the Kates were not registered on a national securities exchange and fit into no other category set out in Regulation U, they were not "margin stock" within that regulation's meaning.

Regulation U bars a grant of credit directly or indirectly secured by any stock for the *purchase* or carrying of margin stock. EA and FDIC argue that the only situation in which Regulation U applies to loans made to a borrower who in turn relends the funds to a third person for the purchase of stock is if the initial borrower is engaged principally or as one of his important activities in the business of extending credit for the purpose of purchasing margin stock. *See* 12 C.F.R. § 221.3(q). They argue that if Regulation U applied to every loan of the type in this case, 12 C.F.R. § 221.3(q) would be superfluous.

It may well be that Regulation U would nevertheless be applicable if the initial borrower were simply interposed as a subterfuge for a bank's avoiding the regulation but that is plainly not the situation here. Plaintiffs were clearly more than nominal intermediaries between FNB and Arnold in light of their own prospective profit. Thus, it cannot be fairly argued that the loan by FNB to the plaintiffs was made for the purpose of purchasing stock within the meaning of Regulation U, even though the funds were ultimately used by Arnold to purchase stock.

As a second claim for relief, plaintiffs allege a pendent claim against FNB based on allegations of common law fraud consisting of alleged misrepresentations of an officer of FNB to the effect that he had reviewed the transaction and that it was regular in all respects. Since there is no federal basis for this suit, there being no Regulation U claim, there is no basis for pendent jurisdiction and the

second claim must therefore be dismissed. Leave to amend to assert this claim under Rule 10b-5 of the Rules and Regulations promulgated pursuant to Section 10b of the Securities and Exchange Act of 1934, as amended, will be denied as unavailing to plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine, *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975).

The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within the scope of the federal securities laws. *See, e.g., McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied* 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick*, [1974-75] CCH Fed. Sec. L. Rep. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974). Thus, even if the FNB loan to Mallis and Kupferman were secured by a pledge of the Equity stock, which is disputed by EA and FDIC, plaintiffs could still not state a claim entitling relief under Rule 10b-5 on that basis since no purchase or sale was involved.

Similarly, there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in question. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize the transaction as a purchase of the stock by plaintiffs are not convincing. To allow persons in plaintiffs' situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under that rule to an extent unealed for by the words of the rule or the statute. *Cf. Bolger* v. *Laventhol, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 267 (S.D.N.Y. 1974).

The third claim seeks relief only against Bankers Trust Company for orally asserting that the stock certificates were no longer subject to the restrictive legend thereon tieing them to an escrow agreement while allegedly having knowledge that the certificates were void.

While this third claim is predicated on fraud under the Securities Act of 1933, as amended, no federal claim is asserted on which relief may be granted since plaintiffs were not "purchasers" of the securities. For the same reason, plaintiffs' offer to amend their complaint to assert a claim under § 10 of the Securities Exchange Act based on this allegation would be unavailing; permission to so amend is denied.

With respect to their offer to amend this third claim, plaintiffs claim that strict adherence to the *Birnbaum* purchaser-seller requirement for 10b-5 suits is no longer mandated in light of the holding in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). This claim is unpersuasive in light of the fact that the plaintiff in *Bankers Life* (the liquidator of Manhattan Casualty Co.) was clearly within the scope of the *Birnbaum* rule. *See Haberman* v. *Murchison*, 468 F.2d 1305, 1311 n.5 (2d Cir. 1972).

In *Bankers Life* the Supreme Court recognized that creditors of a corporation in the process of being liquidated have an interest in a suit brought by the liquidator, but the Court carefully added that

> . . . the fact that creditors of the defrauded corporate buyer or seller may be the ultimate victim does not warrant disregard of the corporate entity . . . The crux of the present case is that *Manhattan* [the corporate seller] suffered an injury as a result of deceptive practices touching *its* sale of securities as an investor. *Bankers Life*, *supra*, at 12-13 (emphasis added)

Opinions in the Second Circuit since *Bankers Life* have reaffirmed the vitality of the *Birnbaum* purchaser-seller doctrine except in a few narrow and irrelevant categories of cases. *Haberman, supra; International Controls Corp.* v. *Vesco*, 490 F.2d 1334, 1343, 1346 n.16 (2d Cir. 1974); *Petersen* v. *Federated Development Co.*, 387 F. Supp. 355, 358 (S.D.N.Y. 1974); *Gurvitz* v. *Bregman*, 379 F. Supp. 1283, 1286 (S.D.N.Y. 1974); *Davidge* v. *White*, 377 F. Supp. 1084, 1087 (S.D.N.Y. 1974); *Goodall* v. *Columbia Ventures, Inc.*, 374 F. Supp. 1324, 1329 (S.D.N.Y. 1974).

Leave to join Arnold and Fowler as involuntary parties pursuant to Rule 19 of the Federal Rules of Civil Procedure is also denied.

Rule 19(a) provides that

> [a] PERSONS TO BE JOINED IF FEASIBLE. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest. . . .

None of the requirements of this Rule are satisfied by plaintiffs' request. In the absence of Arnold and Fowler "complete relief" can be "accorded among those already parties." Dismissal of this action would in no way "impair or impede" the ability of Arnold and Fowler to "protect their interests," nor would it "leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest."

The general rule is that if the merits may be determined without prejudice to the absent party, the Court "will strain hard to reach that result." *Bourdieu* v. *Pacific Oil Co.*, 299 U.S. 65, 70 (1936); *Charron* v. *Meaux*, 60 F.R.D. 619, 622 (S.D.N.Y. 1973).

FDIC has joined in the motion to dismiss submitted by EA and FDIC and EA have submitted a joint brief setting forth their discussion on the viability of the complaint. The positons of those two defendants are identical on these issues. The motion is granted. The first claim is dismissed for failure to state a federal claim upon which relief can be granted. The second claim is a common law claim pendent for jurisdiction on the first claim and is consequently dismissed for lack of subject matter jurisdiction over it.

Bankers Trust submitted two affidavits to the Court urging dismissal of the third claim in the complaint which is asserted against it alone. The plaintiffs have presented their legal arguments on this point and have responded to the Bankers Trust affidavits. That motion is granted. The third claim for relief, the only one directed towards Bankers Trust, is dismissed for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy attempted to be raised therein.

It appears that FNB is an insolvent, whose interests in this case have passed to FDIC and/or EA, and it thus seems appropriate to terminate this litigation in this Court by dismissing the claims as to FNB as well.

Complaint dismissed in its entirety.

So ORDERED.

September 30, 1975

MILTON POLLACK
U.S. District Judge

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 909 (MP)

MEMORANDUM

SAMUR MALLIS and FRANKLYN KUPPERMAN,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and THE BANKERS TRUST COMPANY,

Defendants.

APPEARANCES:

HAUSER & ROSENBAUM
Attorneys for Plaintiffs
350 Fifth Avenue
New York, N.Y. 10001
By: Noel W. Hauser, Esq.

HUGHES HUBBARD & REED
Attorneys for Defendant (Federal Deposit Insurance Corporation as Receiver of Franklin National Bank)
One Wall Street
New York, N.Y.
By: Robert S. Anderson, Esq.

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

SULLIVAN & CROMWELL
Attorneys for Defendant (European-American Bank & Trust Company)
48 Wall Street
New York, N.Y.
By: John L. Warden, Esq.

CHARLES LEEDS, Esq.
Attorney for Defendant (Bankers Trust Company)
1775 Broadway, New York, N.Y. 10019
By: Nathan Silverman, Esq.

MILTON POLLACK, District Judge

Since the filing of the decision in this case, defendant Federal Deposit Insurance Corporation has called the Court's attention to 12 U.S.C. § 1819 (1970), which authorizes suit against this defendant in the federal courts on a state law claim.

Accordingly, the dismissal of Count 2 against this defendant is set aside and liability or any other matter pertaining to that claim alone may be reargued. Counsel should submit briefs accordingly within 10 days hereof.

So ORDERED.

October 2, 1975

MILTON POLLACK
U.S. District Judge

Letter of Noel W. Hauser to Judge Pollack with Attachment, Dated October 1, 1975.

LETTERHEAD OF HAUSER & ROSENBAUM, P.C.

October 1, 1975

Honorable Milton Pollack
United States District Judge
Chambers of the United States Courthouse
Foley Square,
New York, New York

Re: Mallis and Kupferman
—v—
Federal Deposit Insurance Corporation, et al.
75 Civ. 909

Honorable Sir:

Reference is made to my letter to the Court of August 29, 1975 wherein I advanced certain arguments in support of the proposition that the plaintiffs herein should not be denied their day in Court as against Bankers Trust Company, because they were not "purchasers" in the strict sense of the term.

I have obtained a copy of the deposition of Jack Arnold taken in the action commenced by Mallis in Supreme Court, New York County. Arnold was an attorney who executed the investment letter and who appears to be the record purchaser of the securities in question.

At page 15 of the deposition, which was taken on October 10, 1975, Arnold testified (at pp. 15-16) that Mallis' participation was not necessarily that of a lender, but rather as an investor. Copies of those pages are enclosed.

At page 20 of the deposition, he states that in executing the letter of investment, he acted for other as well as

himself. At page 22 of the deposition, he states that he acted for Mallis. Copies of the pages referred to are enclosed.

I would respectfully urge that Arnold's testimony leaves open the question as to whether Mallis was a buyer of a part of the "deal" or whether he was a financier thereof. While it is true that Mallis' compensation was to be limited to $50,000., it is likewise true that the entire transaction might be construed as one where Arnold acted as agent for several purchasers, of whom Mallis was one, with an understanding that the agent's compensation was to include all profit arising from the transaction above that required to reimburse Mallis and yield to him the agreed upon profit of $50,000.

I would respectfully suggest that a mixed question of fact and law is presented as to the nature of Mallis' participation, and that the issue should await a trial.

Respectfully yours,

Noel W. Hauser

NWH:SL
encls.

cc: Sullivan & Cromwell, Esqs. (Attys. Deft. European)
48 Wall Street
New York, N. Y. 10005

Charles Leeds, Esq. (Atty. Deft. Bankers Trust)
1775 Broadway
New York, N. Y. 10019

Hughes, Hubbard & Reed, Esqs. (Attys. Defts. FDIC & FNB
One Wall Street
New York, New York

ATTACHMENT TO LETTER OF OCTOBER 1, 1975.

(15) A. I would says this is the letter.

Mr. Epstein: Referring to Plaintiff's Exhilbt 6, marked for identification in the examination of the Defendant, Fowler, a letter dated March 3rd, 1972.

Q. Now, is that the letter that you prepared on March 1st? A. Yes, sir, or the last day of February.

Q. You gave him an unsigned one, did you not? A. That is correct.

Q. Did this reflect the agreement between you? A. That's right.

Q. Was it your understanding that he was making a loan or making an investment? A. Well, actually it's very difficult to determine what one has in his mind. As far as I was concerned, he was putting up a hundred and fifty thousand dollars in the deal, and he was to get back his money plus fifty thousand dollars. Whether it was a loan or an investment, I don't know, how he would state it.

Q. Upon the remittance of his investment (16) plus $50,000? A. Yes.

Q. What was in your mind when you drew up the papers, signed your signature on the document? A. What was in my mind?

Q. Was it an investment, or a loan? A. It's very hard to be more specific.

Q. It was very hard to be specific what this agreement is? A. An investment, it can also be a loan as well.

Q. You are dilly-dalling with me. A. No, I am not, I am answering the question as best as I can possibly answer it.

Q. In a letter of March 3rd, 1972, you, an experienced lawyer since 1939 or 1940, wrote the word "investment", is that what you mean? A. Probably.

Q. Did you execute a promissory note? A. No.

Q. Did you give him a mortgage? A. No.

Q. Did you give him any security agreement?

• • • • • •

(20) Q. When you signed this agreement or this letter dated March 3rd 1972, Plaintiff's Exhibit 6, for identification, you signed J. Arnold, as attorney, did you not? A. Yes.

Mr. Gluskin: Did you say as an attorney?

Q. Who were you acting for, as you signed that letter? A. I was acting for other people as well as myself.

Q. Which people? A. John Fowler, Mallis, myself, and prior to this deal being consummated, on that day I previously arranged to give Kates $25,000 myself, as the down payment on the sale, and I had somebody who was participating in that with me, who didn't wish to appear in the transaction, and I was acting on his behalf.

Q. On whose behalf?

Mr. Gluskin: I don't think he is at privilege to disclose it.

Mr. Epstein: No.

• • • • • •

(22) Q. Will you fill it in? A. If I can, I will fill it in.

Q. Do you have any records of it? A. I have a record of where they were at that time.

Q. That's the address I want. A. Yes.

Q. Can you fill it in when you execute this examination, if I leave a blank space for this purpose? A. Sure.

(INSERT)

Letter of Noel W. Hauser to Judge Pollack with Attachment, Dated October 1, 1975.

Q. Now, you said in your last answer that among others you were acting for Dr. Mallis, too, is that correct? A. Well, I was talking for everybody, but he also had his own men there as well. Well, I was talking for John Fowler, he was there, as well as I was talking for these people. I took the deal in my name rather than physically speaking for them.

Q. You signed that letter dated March 3rd 1972, addressed to Dr. Samuel Mallis, Plaintiff's Exhibit

• • • • • •

Confidential Litigation Record Prepared for Franklin National Bank.

CONFIDENTIAL LITIGATION RECORD
Specializing in Daily Reports of Litigation in
1/17/72
Greater New York, Westchester and Nassau Counties and Northern New Jersey
8/10/72
241 Broadway, New York 3, N. Y. Telephone: SPring 7-7300
7/12/73

RECORD ON: Creative Cinema, Inc.

ADDRESS: 675 5th Ave., New York, N.Y.

(CODE)

Code	Cause
AD	Advertising
AG	Agreement
AT	Attachment
BC	Breach of Contract
BE	Bill of Exchange
BO	Bond
BW	Breach of Warranty
CF	Confession of Judgment
CH	Check
CO	Commission
CS	Consult Our Office
CT	Contract
CV	Conversion
DR	Draft
FL	Foreclosure on Lien (Chattel)
FM	Foreclosure on Lien or Mortgage (Real Estate)
FR	Fraud
GA	Garnishee
GS	Goods Sold & Delivered
GU	Guarantor
JU	City Court Judgment
LE	Lease
ML	Money Loaned
MR	Money Had & Received
NS	Not Stated
NT	Note or Notes
PR	Premium (Insurance, etc.)
RE	Rent Not Summary or Holdover Proceedings
RP	Replevin
ST	Storage
SV	Services
SJ	Suit on Judgment
TA	Trade Acceptance
UT	Undertaking
VI	Fine, Penalty or Violation
WA	Wage Assignment
WG	Wages
WL	Work, Labor & Services
WM	Work, Labor & Services and Materials Furn.

Date	Amt.	S or J	Plaintiff	Nature of Action
8-8-63	113.50	S	Jef Air Service	WL
10-3-63	545.92	S	Esposito Brothers	GS
10-9-63	227.40	S	Victor Business Machine Co.	GS
10-26-63	1,412.16	S	Mecca Film Laboratories Corp.	WL
10-24-63	444.30	S	Empire State Messenger Service, Inc.	SV
10-21-63	293.63	S	Filmsounds, Inc.	WL
10-22-63	271.31	S	Camera Equipment Co., Inc.	GS
10-28-63	79.47	S	Hartford Accident & Indemnity Co.	PR

In accepting this report, the subscriber agrees that the information contained herein has been compiled from sources and by persons deemed reliable, the accuracy of which is in no way guaranteed.

RECORD FOR: Fr Natl Bank

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
11-4-63	83.64	S	Plaza Paint Supply Corp.	GS
11-4-63	145.91	S	M. Epstein's Son, Inc.	GS
11-14-63	117.65	S	Mercury Service Systems, Inc.	WL
12-3-63			General Assignment Filed for the Benefit of Creditors; Assigned to Stanley B. Hendler 10 E. 42nd St., New York, N.Y. Atty; Leinwand, Maron & Hendler 10 E. 40th St., New York, N.Y.	
11-26-63	1,689.74	S	Pathe Laboratories, Inc.	WM
Creative Cinema, Inc. & Kates, J.B. aka Kates, Jerome B. Served at; 675 5th Ave., New York, N.Y.				
10-2-63	1,210.00	S	Criterion Film Laboratories, Inc.	NT
12-9-70	231.95	S	Carl Moskowitz Assignee TV Competitive Research, Inc. Atty; M.J. Watkins 350 5 Ave., NYC	WL
12-30-70	295.40	S	S & H Messenger Service Atty; I. Finkston 305 B'way, NYC	SV
1-6-71	2,200.00	S	Motion Picture Camera Supply Inc. Atty; Jacobson & Schwartz 160 Broadway, NYC	GS
1-15-71	2,251.69	S	Stuart Gellman Editorial Inc. Atty; Kletsky, Workman, etc. 66 Court St., Bklyn	WL
2-4-71	218.35	S	Harvey Limousine Service Atty; Buchdahl & Lempel 276 5 Ave., NYC	WL
2-16-71	150.68	S	Postalia Corp. Atty; S.K. Field 401 Bway, NYC	SV
3-5-71	1,582.00	S	Diners-Fugazy Travel Inc. Atty; Philip Adelman 10 Columbus Circle, NYC	SV
3/29/71	1103.61	S	S O S Photo-Cine-Optics Inc. Atty Galpeer-Altus 245 Park Ave. NY	GS

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
3/29/71	8170.18	S	F & B/Ceco Inc. of Calif. Atty Galpeer-Altus 245 Park Ave. NY	GS
3/29/71	1780.11	S	F & B/Ceco Inc. Atty Galpeer-Altus 245 Park Ave. NY	GS
Creative Cinema Inc. Address Not Stated				
11/12/63	401.00	S	Owan Davidson Served at 84 William St. NY	WM
Kates, Jerome B.				
3/30/64	Not Given	S	Florman & Babb, Inc. Served at 222 E. 44th St. NYC	GS
Kates, Jerry				
10/1/71	301.50	S	Lentini Creations, Ltd. Attys: Estrow & Levy 529—5th Avenue, NYC	GS
Kates, Jerry dba Take "3" Served at 222 E. 44th St. NYC				
5/15/72	2233.53	S	Lippman Film Service Attys: McKay & O'Keefe 360 Lexington Ave. NYC	SV
1/4/72	460.83	J	Manuf. Hanover Trust Co. Atty: Paul W. Miller, Jr. 1968 Wantagh Avenue, Wantagh LI	Judg
4/7/72	121,506.25	J	Equity Natl. Ind. Inc. Attys: Weiss, Bronston, Rosenthal, Etc. 295 Madison Avenue NYC	Judg
7/6/72	2690.06	S	Beverly Hills Hotel Atty: D R Rothkopf Address Not Stated	SV
Kates, Jerome B. & Judith Served at 80 Poplar Dr., Roslyn NY				
7/20/71	54,795.25	J	Bankers Trust Co. Atty: Charles Leeds 750 3rd Avenue, NYC	Judg
Kates, Jerome B. Served at 78—5th Avenue, NYC				
7/26/71	799.76	S	Sonesta International Hotels Corp. Atty: L. Lambut 2 W. 59th St. NYC	MD
Kates, Jerome B. & Judith Served at 231 Harbor Hill Road, E. Hills				
3/5/71	520.00	J	State Tax Commission	Judg

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
Kates, Jerome B.			Served at; 231 Harbour Hills Rd. E. Hills, NY	
1-13-64	231.00	J	F.A. Bartlett Tree Expert Co.	Judg
5-3-67	147.06	S	Saks & Co. Atty: Corey, Holton, Etc. 91-31 Queens Blvd., Queens	GS
5-12-67	85.23	S	Russell Motors, Inc. Atty: J.M. Decker Address not stated	WL
			Judgment Filed 7-12-67 $113.00	
5-12-67	300.00	S	Izso & Vergati Inc. Atty: J.M. Decker Address not stated	WL
			Judgment filed 7-12-67 $346.00	
8-7-67	177.53	S	Merit Rent A Car Atty: L.K. Batzar Address not stated	$Due
			Judgment filed 8-23-67 $239.00	
3-11-68	2,959.87	S	The Diners Club, Inc. Atty: Leonard M. Weil 10 Columbus Circle, NYC	BC
1-20-69	1,200.00	J	City of N.Y.	Judg
4-7-69	232.31	S	Phila. Sheraton Corp. Atty: M. Schlissel 276 5th Ave., N.Y.C.	SV
Kates, Jerome B. & Take Two, Inc.			Served at; 78 5th Ave., N.Y.C.	
1-8-68	3,508.45	S	Carl Fisher & Carl Fisher Productions, Inc. Atty: Franklin & Weinrib 600 Madison Ave., N.Y.C.	BC, SV
1-6-69	3,431.48	S	Gotham Recording Corp. Atty: Dublirer & Haydon 76 Beaver St., N.Y.C.	GS
Take Two Inc.			Served at; 80 5th Ave., N.Y.C.	
11-17-69	59.60	S	L.I. Insurance Co. Atty: Marcus Seberl 156 William St., N.Y.C.	PB

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
2-16-70	1,342.09	S	Nat'l Recording Studios, Inc. Atty: Joel C. Pender 295 Madison Ave., N.Y.C.	WM
Take Two Inc.			Served at; 230 Park Ave., N.Y.C.	
12-15-69	53.44	S	R.C.A. Global Communications Atty: Frank & Frank 400 Madison Ave., NYC	GS
Take Two Inc.			Served at; 78 5th Ave., NYC	
9-26-67	214.36	S	Maxwell Supply Corp. Atty: H. Resnik 25 W. 43rd St., N.Y.C.	GS
11-22-67	923.31	S	Motion Picture Camera Supply, Inc. Atty: Spector & Paley 50 W. 57th St., N.Y.C.	Rental
12-12-67	12,706.66	S	General Camera Corp. & G.C. Sales Atty: Scioscia & Lashley 16 Court St., Bklyn	BC
3-5-68	117.36	S	Hilton Hotel Int'l, Inc. Atty: Sennet & Schultz 295 Madison Ave., N.Y.C.	SV
4-19-68	7,500.00	S	David J. Hershman Atty: Zuckborg & Z. 261 Broadway, NYC	BC
5-15-68	165.36	S	North River Insurance Co. Atty: Ira H. Subin 51 Chambers St., NYC	PB
5-21-68	71.30	S	Graphic Arts Photo Service Atty: Scheiman, A.M. & T. Time & Life Bldg., NYC	WL
8-9-68	2,100.00	S	Leonard Mandelbaum, Inc. Atty: Kramer & Labaton 295 Madison Ave., N.Y.C.	WM
10-10-68	4,729.87	S	The Optical House, Inc. Atty: Nathaniel M. Sokolski 10 E. 40th St., NYC	WL

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
11-4-68	811.25	S	Hawaiian Village Atty: Richter & Levy 30 E. 42nd St., NYC	$Due
11-12-68	553.02	S	Reeves Broadcasting Development Atty: Blum & Sussman 30 W. 42nd St., N.Y.C.	WM
12-6-68	401.39	S	Eastman Kodak Co. Atty: G. Marshall 60 E. 42nd St., N.Y.C.	GS
12-23-68	173.25	S	Vanleigh Furniture Co., Inc. Atty: Tenzer, Greenblatt, etc. 235 E. 42nd St., NYC	Rental
2-13-69	375.07	S	Gen Camera Corp. Atty: Scioscia & Lashley 16 Court St., Bklyn	Rental
7/17/70	99.75	S	Beacon Temporary Office Service Inc. Atty. R. Becher 160 B'way, NYC	WL
7/27/70	500.00	S	American International Underwriters Corp. Atty. M. Seberl 156 Wm. St., NYC	PR
Take Two Inc. NS Kates, Jerome, NS 80 5th Ave., NYC				
7/31/70	3,254.00	S	Western Costume Leasing Co. Atty. Kazlow & Kazlow 437 5th Ave., NYC Served at 80—5th Avenue, NYC	GS
Take Two, Inc.				
10/8/70	2729.58	S	Opticals East, Inc. Attys: Krause, Hirsch Etc. 41 E. 42nd St., NYC	WL
8/19/70	275.00	S	Lawrence Serves Industry Inc. Attys: Abrams & Cowan 250 W. 57th St., NYC	SV

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
8/19/70	665.60	S	Lawrence Personnel Agency, Inc. Attys: Abrams & Cowan 250 W. 57th St., NYC	SV
2-5-70	53.80	S	Long Island Insurance Co. Atty: Marcus Seberl 156 Wm St., NYC	PR
Kates, Jerome B.			Address not stated	
12-13-68	1,200.00	J	City of N.Y.	Judg
Take Two Inc. & Jerry Kates			Address not stated	
1-10-69	326.00	J	L. Jacobs	Judg
Take Two Inc.			Address not stated	
6-18-68	13,227.00	J	V. Guest	Judg
8-11-69	138.00	J	Russell Motors	Judg
Record On: Take Two Inc. Address: 80—5th Avenue NYC Take Two Inc. 80 5th Ave., NYC				
5/6/70	424.80	S	United Recording Labs Inc. Atty. L. Entin 32 B'way, NYC	GS
6/12/70	407.47	S	Camera Mart Inc. Atty. Florman, Goldstein, etc. Add. 84 Wm. St., NYC	GS
6/22/70	268.52	S	Beiss Bros. Atty. N. Bluestone 26 Court St., Bklyn., N.Y.	GS
9/9/70	1060.00	S	581—10th Avenue Corp. Attys: Coudert Bros. 200 Park Avenue NYC	AG

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
9/14/70	8418.55	S	Zelma Ackerman, As Assignee of Societe Cenematographique Det. Studios "La Victorine" Atty: Edward N. Ackerman 138-16 76th St., Qns.	WL
9/21/70	82.00	S	Temp. Office Services, Inc. Attys: Eisenberg & Solomon Lake Success, NY	SV
Take Two, Inc.			Served at 78—5th Avenue NYC	
8/6/70	2325.00	S	National Helicopter Service & Engineering Co. Atty: Morris Bogash 55 W. 42nd St., NYC	SV
8/6/70	1248.75	S	N TT Enterprises Inc. dba Tyler Camera Systems Atty: Morris Bogash 55 W. 42nd St. NYC	RC
Take Two, Inc.			Served at; 80 5th Ave., NYC	
8-18-70	1,580.86	S	Zane & Zane Atty: Zane & Zane 1 Rockefeller Pl., NYC	WL
			Judgment entered 8-26-70 $1,693.14	
10-9-70	415.00	S	Double Image, Inc. Atty: S.M. Klein 666 5 Ave., NYC	SV, GS
10-23-70	1,513.63	S	Jaris Trading Co., Inc. Atty: Trachtenberg & W 500 5 Ave., NYC	WL
11-6-70	220.50	S	Scenic Backgrounds Inc. Atty: M. Bogash 55 W. 42nd St., NYC	WM

Confidential Litigation Record Prepared for Franklin National Bank.

Date	Amt.	S or J	Plaintiff	Nature of Action
11-9-70	1,106.70	S	Video Tape Products of NY Inc Atty: Black & B. 90-50 Parsons Blvd., Queens	AG
11-17-70	280.21	S	Morse Associates, Inc. Atty: Stozin & S 250 W 57 St., NYC	AG
12-21-70	1,860.15	S	Ocean Science & Engineering Inc. Atty: Leibowitz & Platzer 299 Bway, NYC	AG

Opinion of the Court of Appeals.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 26—September Term, 1976.

(Argued October 18, 1976 Decided January 3, 1977.)

Docket No. 76-7166

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Defendants-Appellees.

Before:

SMITH, OAKES and TIMBERS,

Circuit Judges.

Appeal from judgment entered in the Southern District of New York, Milton Pollack, *District Judge*, 407 F.Supp. 7, dismissing complaint for failure to state claims upon which relief can be granted and denying leave to amend complaint in action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System and of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Opinion of the Court of Appeals.

Affirmed as to dismissal of Regulation U claim; as to dismissal of Securities Exchange Act claim, reversed and remanded with directions.

NOEL W. HAUSER, New York, N.Y. (Hauser & Rosenbaum, New York, N.Y., on the brief), *for Plaintiffs-Appellants.*

JACK H. WEINER, New York, N.Y. (Charles Leeds, New York, N.Y. on the brief), *for Defendant-Appellee Bankers Trust Company.*

PHILIP K. HOWARD, New York, N.Y. (John L. Warden, and Sullivan & Cromwell, New York, N.Y., on the brief), *for Defendant-Appellee European-American Bank & Trust Company.*

ROBERT S. ANDERSON, New York, N.Y. (Hughes Hubbard & Reed, New York, N.Y., on the brief), *for Defendant-Appellee Franklin National Bank.*

TIMBERS, *Circuit Judge:*

This appeal is from a judgment entered in the Southern District of New York, Milton Pollack, *District Judge*, 407 F.Supp. 7, dismissing the complaint for failure to state claims upon which relief can be granted and denying leave to amend the complaint in an action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221 (1976), and alleged viola-

tions of the antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1976).

The essential questions which we find presented and our rulings thereon are as follows:

(1) Whether a bank loan to appellants by Franklin National Bank was subject to Regulation U.

We hold that it was not.

(2) Whether appellants as pledgees of stock certificates of Equity National Industries, Inc. have standing to sue under Section 10(b) and Rule 10b-5.

We hold that they do.

For the reasons below, we affirm the dismissal of the Regulation U claim against European-American Bank & Trust Company and Franklin National Bank; but as to the dismissal of the Securities Exchange Act claim against the Bankers Trust Company, we reverse and remand with directions.

I. Facts

Appellants Mallis and Kupferman are dentists.[1] Between March 1 and March 3, 1972 Jack J. Arnold, an attorney, persuaded them to make a short term loan of $156,000 to himself and his client, John B. Fowler, to finance the purchase of 40,034 shares of stock in Equity National Industries, Inc. (Equity National). The consideration to appellants was to be $50,000. In addition, appellants were to receive possession of the Equity National stock certificates as collateral. To fulfill their part of the

[1] We assume familiarity with the comprehensive statement of facts in the district court opinion. 407 F.Supp. at 9-10.

agreement, appellant immediately obtained a loan of $156,000 from appellee Franklin National Bank (Franklin National). The parties dispute whether this loan was to have been secured in turn by the Equity National certificates. This issue was not resolved by the district court.

Title to the Equity National shares desired by Arnold and Fowler was in Jerome and Judith Kates. But the certificates were in the possession of the Bankers Trust Company (Bankers Trust), to which the Kateses had pledged the shares as collateral for a loan. The Kateses still owed $45,000 on this loan on March 3, 1972.

The shares, which the Kateses had acquired pursuant to a merger between a corporation under their control and Equity National, were subject to an escrow agreement which required the return of the certificates to Equity National for cancellation or reissue depending on whether the acquired corporation met specified earnings conditions. Each certificate bore a legend which declared it to be subject to the escrow agreement and restricted transfer except in accordance with the terms of the agreement. Although other Equity National shares of the same series were registered under the Securities Act of 1933 and listed on the American Stock Exchange (Amex), the shares issued to the Kateses were not.

By a letter to Bankers Trust, Equity National had recalled the Kateses' shares for cancellation in March 1971. As a result the shares were worthless when the transactions here at issue occurred in March 1972.

A closing was held on March 3, 1972. Arnold and Fowler, the Kateses, and representatives of Franklin National and Bankers Trust were in attendance, but not appellants. Franklin National's representative delivered three checks totalling $156,000 to the Kateses. The Kateses endorsed one of the checks in amount of $45,000 to Bankers Trust. Bankers Trust then released the Equity National Certificates. The Kateses transferred the certificates to Arnold

and Fowler who subsequently delivered them to appellants in accordance with the loan agreement.

The instant action arises from the failure of Arnold and Fowler to repay their loan from appellants. In the district court appellants sought to assert two claims. First, they sought relief against Franklin National, now insolvent, and the European-American Bank & Trust Company (European-American), which purchased appellants' note along with Franklin National's other assets.[1] They sought rescission of their loan from Franklin National on the ground that the loan was made for the purpose of acquiring margin stock in an amount in excess of the maximum loan value of the stock in violation of Regulation U.[2] Second, they alleged that Bankers Trust violated the Securities Act of 1933 in disposing of the unregistered Equity National shares in the course of terminating their pledge agreement with the Kateses. During the course of proceedings in the district court appellants departed from this theory, which apparently looked to Section 12(1) of the 1933 Act, 15 U.S.C. § 771(1)(1970), and requested leave to amend their complaint to state a cause of action under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

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[1] The successors in interest to insolvent Franklin National are European-National and the Federal Deposit Insurance Corporation (FDIC).

As the receiver of Franklin National, FDIC was named in the complaint as a defendant with respect to appellants' Regulation U claim. Appellants since have stipulated to dismissal of their action against FDIC. Although Franklin National remains as a party, appellants no longer seek a money judgment against it.

[2] The complaint also alleged a pendant claim against Franklin National based on common law fraud. After dismissing appellants' federal claim against Franklin National, the district court dismissed the pendant claim for lack of subject matter jurisdiction and denied leave to amend it to assert a cause of action against Franklin National under the Securities Exchange Act. Appellants since have stipulated to the dismissal of both of these claims.

The theory underlying their claim against Bankers Trust is that it knowingly misrepresented that the certificates no longer were subject to the escrow agreement.

European-American, Franklin National and Bankers Trust moved to dismiss the complaint for failure to state claims upon which relief can be granted. The court granted the motions and dismissed the complaint in its entirety. In granting the motions of European-American and Franklin National to dismiss the Regulation U claim, the court held that Franklin National's loan was not made for the purpose of carrying or purchasing margin stock within the meaning of Regulation U. In granting the motion of Bankers Trust to dismiss, the court held that appellees, as pledgees, were not "purchasers" of securities and therefore could not state a claim under the 1933 Act. For the same reason the court denied leave to appellants to amend their complaint to allege a claim under Section 10(b) of the 1934 Act and Rule 10b-5.

From the judgment dismissing the complaint and the order denying leave to amend, this appeal has been taken.[3]

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[3] Appellants' notice of appeal filed March 24, 1976 is "from the Order and Judgment of the Hon. Milton Pollack".

Judge Pollack's opinion ordering dismissal of the complaint was filed September 30, 1975. On December 5, 1975, on motion of appellants' counsel, the judge filed a Rule 54(b) certificate directing the entry of a final judgment with respect to all defendants except FDIC so as to permit the instant appeal. We note that Judge Pollack's Rule 54(b) certificate complies with the approved practice in this Circuit that the required determination that there is no just reason for delay "ought not to be made as a matter of rote". *Arlinghaus* v. *Ritenour*, —— F.2d ——, —— (2 Cir. 1976), slip op. 239, 243 (October 26, 1976); *Gummer* v. *Shearson, Hammill & Co., Inc.*, 516 F.2d 283, 286 (2 Cir. 1974). Judge Pollack's finding that "[t]here is no just reason for leaving the claim against FDIC hanging in limbo and creating piecemeal appellate litigation" produced the additional therapeutic result of appellants' dismissal of their action against FDIC. See note 2, *supra*.

(footnote continued on following page)

The district court dismissed appellants' Regulation U claim for rescission against European-American and Franklin National on the ground that Regulation U does not apply to the loan in question. 407 F.Supp. at 10-11. We agree.

Regulation U prohibits banks from extending credit,

> "directly or indirectly . . . for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral. . . ." 12 C.F.R. § 221.1(a) (1976).[3]

The only definition of "margin stock" set forth in Regulation U which even approaches applicability to the instant shares is that of "a stock registered on a national securities exchange". 12 C.F.R. § 221.3(v) (1).[4] Although other shares

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(*footnote continued from preceding page*)

However, since "[e]very good case requires a mystery document", *Westchester Fire Insurance Company* v. *Tantalo*, 273 F. Supp. 7, 12 n. 5 (D. Conn. 1967), it appears that the mystery document here is the judgment itself. Our search of the voluminous appendix and original district court record has failed to uncover any document that looks like a judgment. Since the parties and the district court have proceeded on the assumption that there was an adjudication of dismissal, we decline to stand on the technicality of the missing mystery document in this case.

[3] "Maximum loan values" are set forth in 12 C.F.R. § 221.4 (1976).

[4] 12 C.F.R. § 221.3(v) (1976) defines "margin stock" as:

> ". . . (1) a stock registered on a national securities exchange, (2) an OTC margin stock, (3) a debt security (i) convertible with or without consideration, presently or in the future, into a margin stock, or (ii) carrying any warrant or right to subscribe to or purchase, presently or in the future, a margin stock; (4) any such warrant or right, (5) any security issued by an investment company licensed under the Small Business Investment Company Act of 1958 . . . registered pursuant to section 8 of the Investment Company Act of 1940 . . . unless at least 95 percent of the assets of such company are continuously invested in exempted securities."

of the same series were listed on the Amex, the particular Equity National shares here in question were not listed on any national securities exchange. They therefore were not "margin stock" so as to trigger the application of Regulation U to the Bankers Trust loan.[5]

Moreover, appellants were neither "purchasing" nor "carrying" stock within the meaning of Regulation U. 12 C.F.R. § 221.1(a), *supra*. The Regulation specifically brings within its ambit credit extended to a bank customer engaged "principally, or as one of the customer's important activities, in the business of extending credit for the purpose of purchasing or carrying margin stocks. . . ." 12 C.F.R. § 221.3(g) (1976). Under the circumstances of this case, we construe this provision to state conditions which must be met before the Regulation will apply to an intermediate borrower who reloans the funds to enable another to purchase stock. Appellants, the intermediate borrowers here, had an independent interest in the transaction and bore an independent risk. We therefore need not decide whether we would construe § 221.3(g) otherwise if the intermediate loan were a sham entered into to circumvent the Regulation's application. Since borrowing for the purpose of relending to enable others to purchase or carry margin stock was not one of appellants' "important activities", we hold that Regulation U does not apply to the Franklin National loan.

Furthermore, European-American would be insulated from appellants' rescission claim even if Regulation U were applicable here. Section 29(c)(2) of the 1934 Act, 15 U.S.C. § 78cc(c)(2) (1970), bars construction of the Act or any regulation promulgated under it to afford a defense against "the collection of any debt . . . by any person who

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[5] We agree with the district court's holding that the fact that other shares of the same series were listed on the Amex does not alter the result. 407 F.Supp. at 10-11.

shall have acquired [it] in good faith for value and without actual knowledge of the violation" of the Act or regulation. Regulation U was promulgated pursuant to Section 7 of the 1934 Act, 15 U.S.C. § 78g (1970). European-American's payment of value for appellants' obligation, its good faith, and its lack of actual knowledge of any underlying irregularity are not disputed. Accordingly, even if Regulation U were otherwise applicable, we hold that Section 29(c)(2) would bar appellants from asserting their rescission claim against European-American.

III. Securities Exchange Act Claim

This brings us to what we regard as the chief question in the case: whether appellants have standing to sue under Section 10(b) of the 1934 Act and Rule 10b-5. Specifically, the issue is whether under the definition of "sale" in Section 3(14) of the 1934 Act, 15 U.S.C. § 78c(14) (1970), a pledge fulfills the familiar requirement that the fraud occur "in connection with the purchase or sale" of a security.

In resolving the standing question against appellants, the district court relied on *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5 Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). There the court acknowledged that a pledgor might be liable for fraud under Section 10(b) after his default and a consequent sale of the securities by the pledgee, but held that the pledge itself did not constitute a "sale". At the time of the decision below in the instant case, the district court did not have the benefit of our subsequent decision which rejected the rationale of *McClure* in a case arising under Section 17(a) of the 1933 Act. *United States* v. *Gentile*, 530 F.2d 461 (2 Cir.), *cert. denied*, —— U.S. —— (1976). We hold that *Gentile* and our earlier decision in *SEC* v. *Guild Films Co.*, 279 F.2d 485 (2 Cir.), *cert. denied*, 364 U.S. 819 (1960), control here and require that appellants be granted standing.

In *Guild Films* we held a pledge of stock to be a "sale" within the meaning of Section 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1970),[*] in the context of determining that the pledgees there involved were "person[s] who [have] purchased from an issuer" within the meaning of the definition of "underwriter" in Section 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1970). *SEC* v. *Guild Films Co.*, *supra*, 279 F.2d at 489.[*] *Gentile* reaffirmed and expanded this holding. The defendant there was charged with a conspiracy to pledge fraudulently issued securities in violation of Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970). We again held a pledge to constitute a "sale" within Section 2(3), this time to satisfy the requirements of Section 17(a) that the fraud occur "in the offer or sale of any securities". *United States* v. *Gentile*, *supra*, 530 F.2d at 466-67. We held:

> "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute." *Id.* at 467.[*]

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[*] Section 2(3) defines a "sale" to include "every contract of sale or disposition of a security or interest in a security for value."

[*] We reasoned that the term "purchaser", "although not defined in the Act, should be interpreted in a manner complementary to 'sale'." *SEC* v. *Guild Films Co.*, *supra*, 279 F.2d at 489.

[*] In rejecting the distinction drawn in *McClure* between the pledged shares while in the pledgee's possession and the same shares after a sale due to the pledgor's default, we stated:

> "We see no reason to make the character of the initial pledge dependent upon subsequent events." *United States* v. *Gentile*, *supra*, 530 F.2d at 467 n. 6.

The fact that *Gentile* was a criminal case in which civil standing was not an issue does not diminish its persuasion as a precedent with respect to the Section 10(b) claim before us. The existence of a "sale" is as essential to a criminal prosecution for violation of Section 17(a) as it is to a civil action under that section. We find no basis on the face of either the 1933 Act or the 1934 Act for denominating a pledge as a "sale" for criminal but not for civil purposes.

Nor would the standing policy enunciated by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), support such a conclusion. We recognize that the Court there expressed concern about vexatious suits by a potentially limitless class of plaintiffs. We further recognize that the granting of standing to pledgees creates potential plaintiffs where none might have existed. But a closer look at *Blue Chip* demonstrates that the specific concerns there expressed by the Court have no bearing on the question before us of granting standing to pledgees. The Court in *Blue Chip* had before it a plaintiff who claimed that the defendant's misrepresentations caused it to refrain from purchasing securities. The Court observed that the rule of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2 Cir.), *cert. denied*, 343 U.S. 956 (1952), requiring a purchase or sale, had the virtue of excluding a class of plaintiffs who had not dealt in the security at all and whose cases as a result would stand or fall on oral testimony. Requiring that the plaintiff have "dealt in" the security would assure that each case stand upon at least one "objectively demonstrable fact." *Id.* at 746-47. A pledge which occurs pursuant to a loan contract is just as concrete a transaction as is a normal transfer of title.[11]

[11] Bankers Trust seeks to distinguish *Gentile* and *Gould Films* from the instant case on the further ground that neither of the pledges involved in those cases were bona fide. We fail to see

(footnote continued on following page)

We believe that the rationale underlying our holding in *Gentile* with respect to Section 2(3) and 17(a) of the 1933 Act is persuasive authority for holding that a pledge constitutes a "contract to sell or otherwise dispose of" a security within the meaning of Section 3(14) of the 1934 Act. Accordingly, on the facts of this case, we hold that both a "sale" and a "purchase" may be cognizable under Section 10(b) of the 1934 Act. Appellants were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge.

We therefore reverse the dismissal of appellants' Securities Exchange Act claim and remand the case to the district court with directions to grant leave to appellants to amend their complaint in accordance with this opinion. See *Rogers* v. *White Metal Rolling & Stamping Corp.*, 249 F.2d 262 (2 Cir. 1957), *cert. denied*, 356 U.S. 936 (1958).[12]

Affirmed as to the dismissal of the Regulation U claim against European-American and Franklin National; but as to the dismissal of the Securities Exchange Act claim against Bankers Trust, reversed and remanded with directions to grant leave to appellants to amend their complaint in accordance with this opinion.[13]

(footnote continued from preceding page)

what connection the pledgor's state of mind has with the question whether the pledgee has standing to sue. Such a distinction would be at odds with our rationale in *Gentile*.

[12] Bankers Trust also contends that the dismissal of an earlier common law fraud action brought against it and others by appellants in the New York state courts should have a collateral estoppel effect so as to bar appellants' claim under Section 10(b). This defense is a matter for trial which we do not reach now. But see *Herendeen* v. *Champion International Corp.*, 525 F.2d 130 (2 Cir. 1975).

[13] Having given due consideration to the motion by counsel for European-American for an award of attorneys' fees and double costs, we deny it.

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the third day of January one thousand nine hundred and seventy-seven.

Present: Hon. J. Joseph Smith
Hon. James L. Oakes
Hon. William H. Timbers
Circuit Judges,

76-7166

Samuel Mallis and Franklin Kupferman,

Plaintiffs-Appellants,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged and decreed that the order and judgment of said

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit.

District Court be and they hereby are affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court with costs to be taxed against the plaintiffs-appellants in favor of defendant appellee European American Bank & Trust Company and against defendant-appellee Bankers Trust Company in favor of plaintiffs-appellants.

A. Daniel Fusaro
Clerk

by Arthur Heller
Deputy Clerk

Order of the Supreme Court of the United States, Granting the Petition for a Writ of Certiorari.

SUPREME COURT OF THE UNITED STATES

No. 76-1359

Bankers Trust Company,

Petitioner,

v.

Samuel Mailis and Franklyn Kupferman

ORDER ALLOWING CERTIORARI Filed May 23, 1977

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted.

In The

Supreme Court of the United States

October Term, 1976

Supreme Court, U.S.
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APR 29 1977
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No. 76-1359

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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In The

Supreme Court of the United States

October Term, 1976

No.

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

This brief is submitted in opposition to the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit filed by petitioner, Bankers Trust Company.

JURISDICTION

The jurisdiction of this Court is not contested.

QUESTIONS PRESENTED

1. Whether a commercial bank, having received stock as security for a loan may with impunity, fraudulently and with scienter represent to a prospective redeemer of the stock other than the pledgor, that the same has value when it is in fact worthless paper.

2. Whether the anti-fraud provisions of the Federal Securities Laws do not apply to a commercial bank simply because a commercial bank is not primarily in the securities business.

ARGUMENT

The decision by the Second Circuit does not raise an issue of public importance.

The position taken by Bankers Trust Company in its brief in support of the petition for a writ of certiorari is that a pledge of stock, even if induced as a result of fraud, does not fall within the ambit of the anti-fraud provisions of the Federal Securities Laws; and that, *a fortiori,* there can be no fraud when, *without more,* the parties are placed in status quo by a redemption of the pledge. The petitioner then goes on to urge that this is such a case, citing *McClure v. First National Bank of Lubbock Texas,* 497 F.2d 490 (C.A. 5 1974), *cert. denied,* 420 U.S. 930 (1975).

The difficulty with the argument is that the facts do not fit into that mold, but rather into a different mold as to which the opinion in the *McClure* case held that there would be liability.

McClure involved an even more simplistic set of facts then those suggested by the petitioner. There, the plaintiff alleged that she had been fraudulently induced in the original instance to guarantee repayment of a loan; that she pledged stock for an extension of the loan which had in the original instance been fraudulently induced. She sought to be exonerated from her plight although she had not repaid the loan and although the pledgee still held the stock. That is not this case.

Here, such rights as the defendant enjoyed as pledgee were surrendered upon receipt of monies generated by a third party, the plaintiffs. As the opinions of the District Court and the Court of Appeals indicate, the plaintiffs, who were strangers to

all parties until the day of the transaction which gives rise to this litigation, arranged to borrow $156,000 from Franklin National Bank, whose officer attended a closing in their behalf at which time a Franklin National Bank check was delivered to Bankers Trust Company to redeem the stock; the pledge having been redeemed the securities in question were delivered by Bankers Trust Co. to the officer of Franklin National Bank who was acting in behalf of the plaintiffs. It is claimed that the representative of Bankers Trust Company in attendance at the closing affirmatively represented that the securities were valid, sound and subsisting securities and were what they purported to be when in fact the record in the court below establishes without dispute, that Bankers Trust Company was on actual notice from the issuer for at least a year prior to the closing that the securities were worthless. Indeed, the issuer had, about a month prior to the closing, filed a complaint in the Southern District of New York naming Bankers Trust Company as a defendant in an action to recover possession of the worthless securities, but the record does not reflect whether the summons had been served upon Bankers Trust Company prior to the closing.

Nothing in *McClure, supra,* called for a conclusion other than that reached by the Second Circuit in this case. On the contrary, the language of *McClure* supports the conclusion reached by the Second Circuit in this case although this was apparently overlooked by the latter court. The *McClure* court had the following to say about the implications arising from the disposition by a bank of stock originally obtained as a pledge other than by return to the pledgor:

> "If the bank sells the stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender, does

> not, of itself, bring within the scope of the Federal Securities Act a transaction otherwise outside their purview. See 1 L. Loss Securities Regulation, 649 (Second edition, 1961)."

The court then went on to distinguish *S.E.C. v. Guild Films Co.*, 279 F.2d 485 (C.A. 2), *cert. denied*, 364 U.S. 810 (1960), and other cases which found liability under the Securities Laws against a pledgee bank.

While not necessarily germane to the question of whether or not certiorari should be granted in this case, it may nevertheless be observed that the decision by the court in *McClure, supra*, is not inconsistent with the decision reached by the Second Circuit in *United States v. Gentile*, 530 F.2d 461 (C.A. 2), *cert. denied*, ___ U.S. ___ As heretofore observed, the *McClure* case involved the pledge of valid securities as further collateral for a pre-existing loan whose grant had allegedly been fraudulently induced. The fraud related to the loan, not the securities, which were in any event, wholly redeemable by the victimized pledgor. In *Gentile*, the securities pledged were worthless, and the pledgees were fraudulently induced to advance an original consideration in the form of a loan to a pledgor. In this connection, the *McClure* opinion states:

> "We do not doubt that a pledge of securities can constitute a 'sale' in some cases, but we hold that the pledge was not a sale in the circumstances of this case."

None of the cases cited by the petitioner as being inconsistent with the decision by the court below in this case is in fact inconsistent; on the contrary, they are in every respect consistent. The decision of the Second Circuit was eminently correct and supported by all of the authorities and no sound reason exists for this Court to grant certiorari.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

s/ Noel W. Hauser
Attorney for Respondents

Supreme Court, U. S.
FILED
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No. 76-1359

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

BANKERS TRUST COMPANY,
Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

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August 18, 1977

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1359

BANKERS TRUST COMPANY,
Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

Opinion Below

The opinion of the United States District Court for the Southern District of New York dismissing the complaint is reported at 407 F. Supp. 7 (A.128-137).[1] The opinion of the court of appeals (A.154-165) is not yet officially

[1] "A." refers to the Appendix heretofore filed with the Court. "App." refers to the Appendix at the end of this Brief.

reported, but is unofficially reported at CCH Federal Securities Law Reporter at paragraph 95, 823. The memorandum Opinion of the Trial Court, Supreme Court, New York County in the related case of *Mallis* v. *Kates, et al.* (A.88-90) is not officially reported.

Jurisdiction

The judgment of the Court of Appeals was entered on January 3, 1977 (A.166-167). A timely Petition for a Writ of Certiorari was filed on April 4, 1977, and granted on May 23, 1977 (A.168). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

Statutes and Rules Involved

The relevant provisions of the Securities Exchange Act of 1934 as amended (48 Stat. 881, 15 U.S.C. Section 78a et seq.), the Securities Exchange Commission's Rules and Regulations 17 C.F.R. (Code of Federal Regulations) 240 et seq. and the New York Uniform Commercial Code are set forth in the Appendix, infra.

Questions Presented

1. Whether a plaintiff which receives a pledge of stock as collateral for a loan is a buyer of securities within the meaning of Section 3(a)(13) of the Securities Exchange Act of 1934 for purposes of a civil damage action under Section 10(b) and Rule 10b-5 promulgated thereunder?

2. Whether the requirements of Section 10(b) and Rule 10b-5 that a fraud to be actionable under the Securities Exchange Act be committed "in connection with the purchase or sale of any security" is satisfied where the alleged

"sale" is the release of collateral by a commercial bank of pledged stock upon repayment of its loan, and the alleged "purchase" is the pledge of the shares by a third party to the unknown plaintiffs?

Statement of the Case

This action was instituted by Samuel Mallis (hereinafter "Mallis") and Franklyn Kupferman (hereinafter "Kupferman") alleging *inter alia* that Bankers Trust Company (hereinafter "Bankers Trust") was prohibited by the 1933 Securities Act from receiving a pledge of securities from Jerome and Judith Kates (hereinafter "the Kates") in August 1970 as collateral for a loan and that by virtue of the Securities Act, Bankers Trust was prohibited "from disposing of the aforesaid securities, except to redeliver the same to the said Jerome Kates or Judith Kates, or the issuer" (A.11). The complaint further alleged that Bankers Trust transferred the securities to plaintiffs or their nominee in violation of the 1933 Act for which Bankers Trust received from another bank, Franklin National Bank (hereinafter "FNB"), the sum of $45,000 as part of the proceeds of a loan by FNB to Mallis and Kupferman (A.11). The courts below treated the complaint and subsequent affidavits as a 10(b) and Rule 10b-5 action under the 1934 Securities Exchange Act (A.135-136, 158, 162).

After an answer had been filed by Bankers Trust (A.50-52) and on motion to dismiss (A.124), the United States District Court granted the motion to dismiss, since the plaintiffs were not "purchasers" within the requirements of the *Birnbaum* doctrine as adopted in *Blue Chip Stamps* v. *Manor Drug Stores* (A.134). Although recognizing that under *Blue Chip Stamps* the plaintiff must be either a purchaser or seller, the court of appeals reversed and held that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A.165).

A. The Underlying Facts

The motion to dismiss was made six months after the filing of the complaint and the intervening affidavits and documents attached thereto were construed by the District Court as having augmented the complaint for purposes of this proceeding. The facts are well set forth in the opinion of the District Court (A.128-137) and in the opinion of Mr. Justice Nadel of the State Supreme Court (A.88-90).

1. The Bank's Loan and the Pledge of the Collateral.

Bankers Trust is a commercial bank regulated by the New York State Banking Department and the Federal Reserve Board. As such, it makes loans based on criteria of creditworthiness, whether such loans are secured or unsecured.

In August, 1970, Kates, who is not a party to this action, applied to Bankers Trust for a $50,000 loan (A.56, 102). As collateral, he pledged to Bankers Trust 40,384 shares of stock of Equity National Industries, Inc. (hereinafter "Equity National") belonging to both himself and his wife (A.56).

At the time Bankers Trust accepted the collateral as security for the loan, Bankers Trust believed the shares of stock to be valuable and received an opinion letter from counsel that the shares of stock delivered to Bankers Trust as collateral by Mr. & Mrs. Kates "although bearing the usual restrictive legend covering unregistered securities, will become eligible for public sale without registration after 6 months from the date of closing on August 7, 1970" (App. 50, A.56-57).[2] At that time, everyone expected the loan to be repaid to Bankers Trust by Kates and the collateral returned to Kates.

---

[2] The opinion letter is part of the record in the pending State Court actions and is reproduced infra (App. 47-50).

Kates reduced his indebtedness to Bankers from $50,000 to $45,000 by making monthly payments (A.57). By letter of March 1, 1971, Equity National notified Bankers Trust that the earnings requirements had not been met for 1970 and requested that the shares issued to the Kateses, some of which had been pledged to Bankers Trust, be returned to Equity National for cancellation (A.96-100, 105). Bankers Trust was contacted by Kateses' attorney, who informed Bankers Trust[2] (App. 51-52):

> "• • • we have advised our clients that notwithstanding any controversy between Equity and them respecting the conditions of issuance of the Securities, since they delivered them to you as collateral for the loan, they have every right to expect you to return the Securities to them upon repayment of the loan.
>
> This letter is intended to advise you that our clients will hold you fully responsible for any damages which may be sustained by them in the event you fail to return the Securities to them at such time as your loan to Mr. Kates has been repaid."

As a result of the conflicting correspondence, Bankers Trust's attorney advised Equity National's attorney that the aforementioned shares of stock "were delivered to the Bank by Jerome B. Kates as collateral security for loans made to him and will be returned to him only when said loans are repaid". The letter went on to say (A.105, App. 53):

> "Bankers Trust Company does not intend to get into any dispute that you may have concerning his right to the said shares of stock.

---

[2] These documents were part of the proceedings in the State Court.

> Moreover, the Bank has been put on written notice by the attorneys representing Mr. Kates, not to release the said collateral upon penalty of damages. If your client is disposed to furnishing the Bank with an Indemnity bond to fully protect the Bank in this matter, we will consider your client's demand. Otherwise, you may consider this letter as a rejection."[4]

Bankers Trust did not hear anything further from Equity until March 10, 1972, one week after it had returned the certificates of stock to the Kateses.

2. The Return of the Collateral to the Kateses.

Bankers Trust was informed by Kates that he sought to redeem his stock and that he had obtained a purchaser for the Equity National shares (A.59).

A closing was held at the offices of the Attorneys for Bankers Trust on March 3, 1972. Present at the closing were Kates, John B. Fowler, Jr., a stockbroker, Jack J. Arnold, an attorney, and John A. Murfitt, an Assistant Vice President of FNB (A.59). Murfitt was present as the representative of FNB (A.18).[5] Mallis conceded in the State Court proceeding that he "personally had no contact with the knowing defendants [including Bankers Trust]" (A.77).

The office of the Bank's attorney was utilized merely "as a facility to accommodate the parties involved. [Bankers

[4] This is part of the record in the State Court proceeding, reproduced infra, App. 53.

[5] Although the brief in opposition attempted to characterize Murfitt as Mallis' agent, this is contrary to Mallis' affidavit that "Murfitt in behalf of Franklin, attended" (A.18). Mallis had previously testified in the State Court action that Murfitt "didn't represent me" and he thought that he was represented by his attorney Jack Arnold. Indeed, Mallis had instituted a cause of action in malpractice against his attorney Jack Arnold (A.72-73. See also p. A74).

Trust's attorney] did not know and was never told the name of the purchaser, nor was [he] interested." (A.59). The attorney "merely stood on the 'sidelines' during the closing . . ." (A.59-60). See A.75-76 where Mallis swears that Bankers and its attorney remained silent.

The stock certificates were exhibited at the closing. The certificates bore a legend in bold type which declared the stock subject to an Escrow Agreement, and restricted transfer in accordance with the terms of the agreement (A.88-89, 60, 86, 32-39). Arnold asked for and received an affidavit from Kates to the effect that the legend in no way restricted the transfer of shares and that the "particular shares involved have been released from the Escrow Agreement" (A.84, 59, 60, 79, 86).

The FNB representative delivered the checks to Kates, including one check in the amount of $45,000 payable to Kates and Bankers Trust (A.60, 102-103). Bankers Trust's attorney refused to accept these checks since Bankers Trust "was not a party to the transaction involved" (A.60, 102-103). Bankers Trust's attorney insisted that the name of Bankers Trust as co-payee be stricken from the check (A.60-61, 102-103). This was done and the check was issued by FNB to Kates (A.60, 103). Kates then endorsed the check over to Bankers Trust (A.60, 27); whereupon Bankers Trust in accordance with Section 9-506 of the Uniform Commercial Code released and returned to Kates the previously pledged stock certificates (A.106). Bankers Trust applied the monies to a repayment of the loans made by Kates and considered the matter closed on March 3, 1972.

One week later on March 10, 1972, Bankers Trust was served for the first time with a complaint by Equity National to obtain a cancellation of the certificates of stock (A.105).[6] This action was discontinued against Bankers

[6] *Equity National Industries, Inc.* v. *Jerome B. Kates, et al.* including *Bankers Trust* (S.D.N.Y. 72 Civ. 503).

Trust (A.105). This lawsuit was the beginning of a series of lawsuits which subsequently made Bankers Trust aware for the first time of the transactions between Kates, Arnold and Fowler on one side and Mallis and Kupferman on the other.

3. The Transactions Between Mallis and Kupferman, and Kates, Arnold and Fowler to Which Bankers Trust Was Not a Party.

Prior to the closing on March 3, 1972, the negotiations between the plaintiffs Mallis and Kupferman and Arnold, Fowler and Kates had been completed. Bankers Trust is not alleged to have had knowledge of either the negotiations or the substance of the agreement. The closing was merely a formal ritual.

The parties to the transaction were Kates, Mallis, his brother-in-law Kupferman, Jack J. Arnold (hereinafter "Arnold") and John B. Fowler, Jr. (hereinafter "Fowler").

Mallis is a sophisticated and successful dentist. During the early 1970's, he speculated in various financial ventures. When the matter did not succeed, he resorted to both the State and Federal courts as in this case.[1]

Arnold was an attorney who has represented Mallis on prior occasions and had dealt with him as an entrepreneur (A.107-108, 64, 72-73). Fowler was a stockbroker and an officer of J. S. Love & Co. (A.16, 64).

On February 24, 1972, a week before the closing, the Kateses and Arnold entered into an agreement whereby the

[1] In another action, *Mallis* v. *Roggen and Layne* (E.D.N.Y. 74 Civ. 1610) Mallis is suing under Section 10(b) and Rule 10b-5 to recover monies allegedly lost by Mallis, "his family and friends" in a private placement of securities in late 1969 when the "plaintiff Samuel Mallis . . . passed the information that (the defendants) had given to him, to his family and friends, to induce them to purchase the aforesaid units in Designare."

Kateses assigned all of their right, title and interest to the stock for $4.50 a share or a total of $181,728 (A.23-25). In that agreement, Kates represented and warranted to Arnold that the Equity National stock was "validly issued, duly authorized, and outstanding on the books of Equity National Industries, Inc." (A.24). At the time of the agreement, Arnold made a $25,000 partial payment to the Kateses (A.23). Simultaneously, Kates gave Arnold an option to purchase "110,000 shares of common stock of Merck & Co., Inc. at sixty (60%) percent of the then existing market price to be determined by computing the preceding five days average closing price" (A.82).

On March 1, 1972, Arnold contacted Mallis and informed him that he had already advanced $25,000 to purchase the stock and that he needed an additional $156,000 to complete the purchase or the deposit would be forfeited (A.16, 107). Arnold told Mallis that although the securities were unregistered, the securities would soon become marketable by virtue of a new Regulation promulgated by the Securities and Exchange Commission (A.130, 16, 108). Arnold further told Mallis that the market value of the stock was between $10-13 per share which was "several times the purchase price of $181,000" or "at least $400,000" (A.16, 108, 130). Arnold persuaded Mallis and Kupferman to make a short-term loan of $156,000 to Arnold and Fowler (A.16, 108). Mallis and Kupferman contacted FNB which advised them that the transaction appeared to be in order and "recommended that plaintiffs become the borrowers so as to facilitate Franklin's advancement of the funds as required by Arnold, Fowler and Love & Co." (A.18, 17, 108). On March 3, 1972, Mallis and Kupferman executed the necessary documents whereby they borrowed the money from FNB. As noted by Judge Pollack, Mallis and Kupferman then proceeded to make a short term loan to Arnold and Fowler of $156,000 for which Mallis and Kupferman were to receive interest of $50,000 for thirty days (A.130, 156, 49, 108, 56).

Arnold, by letter of March 3, 1972, agreed that the Equity National shares were "to be held as collateral by Mallis" for this loan and pointed out (A.49):

> "There is currently pending a transfer pursuant to a written option a block of 100,000 shares of Merck & Co., out of which proceeds you will be reimbursed for the total sum of monies accruing to you. This transfer will be completed during March, 1972."

Arnold did not repay the moneys within the agreed upon 30 days. Instead of the $206,000 which he had contracted to receive, Mallis only recovered $50,000. Mallis claims that he is entitled to recover not only the unpaid balance of $106,000 on the moneys loaned to Arnold and Fowler, but also the $50,000 "finders fee" for a total balance still claimed by Mallis of $156,000 (A.71, 72, 80, 19).[8]

B. Judicial Proceedings

Subsequent to this time, Mallis instituted lawsuits against Bankers Trust in both State and Federal Courts, and Kupferman joined him in the Federal Court.

1. The State Court Proceeding

On December 11, 1972, Mallis instituted an action against Bankers as well as other defendants in the state court charging Bankers with both fraud and negligence in permitting "escrowed stock" to be delivered to the possession of Kates "by its silent acquiescence" thereby allegedly aiding and abetting a fraudulent transaction (A.63-76, 68-69, 74-75).

At the same time he brought actions against (1) Arnold and Fowler claiming a breach of contract (A.71-72); (2) Arnold claiming malpractice (A.72-73); and (3) the

[8] At the time of filing the complaint in this action, they still had not repaid the monies owing to FNB (A.18-19).

Kateses and their attorney claiming fraudulent concealment of facts (A.73-74). In dismissing the complaint against Bankers Trust, the court ruled (A.89-90):

> "The leading case on where there is a duty to speak is Amend v. Hurley, 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this 'investment', the Equity shares are called 'collateral' and he is guaranteed *repayment* out of another stock transaction.
>
> The 'fraudulent concealment' he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend."

An order of dismissal was entered (A.91-92) and no appeal was taken.[9]

[9] The state court action against Arnold, Fowler and the Kateses is still pending. Soon after the dismissal, Arnold issued a third-party complaint against Bankers Trust seeking judgment over if Mallis should recover against Arnold in the State Court proceeding. In August, 1975, Arnold, who was being sued for malpractice, sought and was ultimately granted leave to amend his third-party complaint against Bankers Trust (*Mallis* v. *Kates*, 52 A.D.2d 303, 383 N.Y.S. 2d 26, 27 (1st Dept., 1976)). Fowler likewise instituted a third-party complaint seeking indemnity from Bankers Trust. The State Court denied the motions to

(footnote continued on following page)

2. The District Court Decision

In February, 1975, Mallis and Kupferman instituted this action alleging that Bankers Trust had violated the Act by transferring the securities to the plaintiff—apparently through Kates paying off the loan and selling the securities to Arnold and Fowler, who then pledged the securities to plaintiff—in order to recover $45,000 (A. 10-11). They also claimed that they had no obligation to repay their loan from FNB because the transaction violated Regulation U, 12 C.F.R. 221 promulgated under Section 7 of the 1934 Act, 15 U.S.C. Section 78g, and sought the return of all moneys paid to FNB for principal and interest (A.6-9, 12). The court dismissed the claim against Bankers for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy (A.137). The court reasoned that the claim was barred to (A.134):

> "plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine. *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975)."

The court also held that plaintiffs could not invoke Regulation U to avoid their obligation to FNB since "no purchase or sale was involved." (A.134)

3. The Court of Appeals Decision

On appeal, the court of appeals affirmed the holding of the district court that Mallis and Kupferman were

(footnote continued from preceding page)

dismiss the third-party complaints on the pleadings, setting forth that it would seem more economical "to have one trial at which the rights of all the parties arising out of these inter-related transactions can be adjudicated." *Mallis* v. *Kates*, —— A.D. 2d ——, 393 N.Y.S. 2d 18, 19-20 (1st Dept. 1977). Cf. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 738, n.9.

obligated to repay their loan from FNB since they were neither "purchasing" nor "carrying" stock within the meaning of Regulation U. (A.161).

As to Bankers Trust, the court of appeals reversed and held Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A.165). Accordingly, the court of appeals found that Mallis and Kupferman had standing to sue.

The court did not explain how the same pledge of stock from Arnold and Fowler to Mallis and Kupferman was not a "purchase" for purposes of a Regulation U claim under Section 7g (15 U.S.C. Section 78g), but was a "purchase" for purposes of a claim under Section 10(b) and Rule 10b-5.

Summary of Argument

The 1934 Securities Exchange Act was not intended to federalize all transactions in securities and to include within it all persons and every allegation of fraud traditionally relegated to state law, *Santa Fe Industries Inc.* v. *Green*, 430 U.S. ——, 97 S. Ct. 1292, 1302-1304. To be actionable under Section 10(b) and Rule 10b-5 of the 1934 Act, not only must the complaint allege fraud but it must allege (1) a "purchase or sale" of a security by the plaintiffs and (2) the alleged fraud must be "in connection with" the purchase or sale (15 U.S.C. Section 78j). The instant complaint did not satisfy each of these requirements. The plaintiffs Mallis and Kupferman were not purchasers but lenders; and Bankers Trust was not a party to the transaction but merely released its collateral to its debtor upon repayment of an outstanding indebtedness.

1. The court of appeals erroneously concluded that the purchaser-seller requirement was satisfied whenever there

was a pledge transaction. This holding is contrary to *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, the plain language of the Act, and the legislative history. Sections 3(a)(13) and (14) define the terms "buy" and "purchase" and "sale" and "sell" for purposes of the 1934 Act. 15 U.S.C. Sections 78c(a)(13) and (14). Neither definition includes a pledge. Both at common law and under the Uniform Commercial Code, a "pledge" of securities is not a "purchase" or "sale", but merely the delivery of a security interest in the collateral. Upon repayment, the pledgee has the duty to return the collateral to the debtor-pledgor. Congress had recognized this distinction. Thus, when Congress wanted to include a "pledge" within the statutory definition of "sale", it did so. See Public Utility Holding Company Act, 15 U.S.C. Section 79b(a)(23).

2. Nor did the release of the pledged stock to the Kateses upon repayment of the indebtedness subject Bankers Trust to a civil action under Section 10(b) and Rule 10b-5. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (C.A. 5). Federal legislation was not needed for privately negotiated pledge transactions between borrowers and lenders. 1 Loss, *Securities Regulation* (2d ed. 1961) 649. All rights and remedies between the two could be resolved by state law. The Securities Exchange Act should not be expanded to include all banking transactions cognizable under state law merely because the indebtedness had been collateralized by stock. Such an expansion would burden both the Federal Courts and the banks, whenever disgruntled borrowers seek to institute such proceedings to avoid and delay payment of an outstanding indebtedness. *Blue Chip Stamps*, 421 U.S. at 740.

3. Bankers Trust's release of the securities to the Kateses was not "in connection with" the pledge of securities to the plaintiffs. Mallis and Kupferman made no inquiries of Bankers Trust. The loan agreement had been

fully completed prior to the closing not attended by Mallis and Kupferman. Mallis and Kupferman did not look to the Equity National stock for repayment of the loan, but to another transaction. The factual matrix demonstrates that there was no "connection" between the pledge of stock to Mallis and Kupferman and Bankers Trust.

ARGUMENT

Introduction

To fall within the scope of Section 10(b) of the Securities Exchange Act and Rule 10b-5, the fraud alleged by the plaintiff must be "in connection with the purchase or sale of any security" (15 U.S.C. Section 78j). This Court has held that only a purchaser or seller of a security may maintain a private cause of action "in connection with the purchase or sale of securities" for damages suffered under Section 10(b) of the Securities Exchange Act and Rule 10b-5. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733; *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6, 12-13. For a complaint to be actionable under the Securities Exchange Act, not only must the complaint allege fraudulent conduct, but also must allege (1) the purchase or sale of a security, and (2) a nexus between the alleged fraud and the transaction. These two elements were plainly not satisfied in this case and Judge Pollack rightly dismissed the complaint for lack of standing.

The court of appeals erroneously, we submit, attempted to limit this Court's decision in *Blue Chip Stamps* by holding that on the facts of this case, there were "both a 'sale' and a 'purchase'" cognizable under Section 10(b) of the 1934 Act. The court of appeals concluded that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A.165). This conclusion ignores the fact that the

two transactions were separate and distinct. The return of the collateral by Bankers Trust to Kates was one transaction. The pledge by Arnold and Fowler to Mallis was a completely separate transaction of which Bankers Trust was not aware until after the institution of these lawsuits. In combining the two transactions to justify a cause of action, the court of appeals ignored *Blue Chip Stamps* and held, as did the dissent therein, that "a remedy exists under Rule 10b-5 whenever there is a 'logical nexus between the alleged fraud and the sale or purchase of a security'" (421 U.S. at 736 n.8)

I. Mallis and Kupferman clearly lack standing to maintain a cause of action against Bankers Trust under the Securities Exchange Act of 1934 since as pledgees they were plainly not purchasers or sellers of securities as required by this court in *Blue Chip Stamps*.

The court of appeals erroneously held that the purchaser-seller requirement of Section 10(b) and Rule 10b-5 was satisfied whenever there was a pledge transaction (A.162-165). This holding is contrary to the decision of this court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), the plain language of the statute, and the legislative history of the Act.

As "made clear" by this Court in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. ——, 97 S.Ct. 1292, 1300, "in deciding whether a complaint states a cause of action for 'fraud' under Rule 10b-5, we turn first to the language of Section 10b-5 for '[t]he starting point in every case involving construction of a statute is the language itself.'" *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197, *Blue Chip Stamps, supra*, at 756 (Powell, J. concurring).

For purposes of the 1934 Act, Congress defined the terms "buy" and "purchase" and "sale" and "sell". Section

3(a)(13) of the Securities Exchange Act of 1934 defines "buy" and "purchase" to "include any contract to buy, purchase or otherwise acquire" (15 U.S.C. Section 78c (a)(13)). The terms "sale" and "sell" are defined to "include any contract to sell or otherwise dispose of" (15 U.S.C. Section 78c(a)(14)). Neither definition includes a pledge which is merely a security interest in collateral. Neither a pledge of stock nor its redemption brings the transaction within the "purchase" and "sale" requirements of Section 10(b) and Rule 10b-5.

A. The pledge of securities as collateral for an indebtedness is not a "purchase" or "sale" within the meaning of the 1934 Securities Exchange Act.

At common law, a pledge of securities occurs whenever a debtor physically delivers collateral to a secured party and the pledge is perfected when the collateral comes into the possession of the secured party. The goods are kept by the creditor until the debt is repaid. Legal title remains in the pledgor. Black's Law Dictionary, 1312 (4th Ed. 1957). The pledgee occupies a fiduciary relationship with the pledgor. *Easton* v. *German-American Bank*, 127 U.S. 532, 536-537 (1888). Upon default, the pledgee does not keep the property as payment of the debt, but merely has the right to sell the property to liquidate the debt and the excess proceeds from the sale must be remitted to the pledgor.

Article 9 of the Uniform Commercial Code as enacted in New York and most states has codified the law regulating secured transactions including a security interest in stock certificates. UCC Section 1-201(37) defines "security interest" to mean "an interest in personal property or fixtures which secures payment or performances of an obligation." The Official Comment to UCC Section 9-101 makes it clear that "the Article applies to all transactions intended to create security interest in personal property

and fixtures . . ." UCC Section 9-305 provides for the perfection of a security interest in stock certificates by possession and without the need for any filing.

The rights and duties of both the debtor-pledgor and the creditor-pledgee are carefully delineated. UCC Section 9-207 sets forth the standard of care to be followed in the preservation of the collateral when collateral is in the secured party's possession and the duty to use reasonable care in the custody and preservation of the rights of the debtor against all other parties.

New York Law clearly sets forth the obligation of parties in the event of default, including the debtor's right to "redeem the collateral by tendering fulfillment of all obligations secured by the collateral." (UCC Section 9-506). As at common law, "if the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus . . ." (UCC Section 9-502(2)). The secured party may only dispose of collateral by sale in a "commercially reasonable" manner and is required to apply the net proceeds to the satisfaction of the indebtedness (UCC Section 9-504(2)). If the pledgee-secured party does not act in accordance with these and the other prescribed standards, the debtor has the "right to recover from the secured party any loss . . ." (UCC Section 9-507(1)).

There has been nothing since the enactment of the 1934 Securities Exchange Act to change the common law definition of a pledge as a mere security interest and not a "sale" or transfer of title in property.

B. Mallis and Kupferman clearly lack standing to maintain an action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 since, as pledgees, they were not purc[illegible]rs or sellers of securities as required by *Blue Chip Stam*

This Court has held that only a purchaser or seller of a security may maintain an action for damages under

Section 10(b) of Securities Exchange Act and Rule 10b-5. *Blue Chip Stamps, supra.*

Congress specifically defined the terms "buy" and "purchase" and "sale" or "sell" for purposes of that Act. Congress did not follow the definitions in the 1933 Securities Act but narrowed the definitions."

As we have shown *supra*, a pledge of stock, both at common law and under the Uniform Commercial Code, is not a sale of securities, but merely the delivery of a "security interest" in collateral to a creditor. The underlying obligation continues to be either a note or a contract. The ultimate interest in the securities pledged as collateral remains in the pledgor since the pledgee must act with due diligence (UCC Section 9-207). The pledgor retains the right of redemption at any time and the pledgee is obligated to remit to the pledgor any receipts in excess of the obligation. See generally Sections 9-504 to 9-506 of the Uniform Commerical Code, discussed *supra*.

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[10] See *Blue Chip Stamps, supra*, 421 U.S. at 750-751, n.13, where this Court noted:

"These provisions as enacted starkly contrast with the wording of the bill which became the 1934 Act when it emerged from committee and was presented on the Senate floor by Senator Fletcher, the chairman of the Senate Committee on Banking and Finance. See S. 2693, 73d Cong., 2d Sess. (1934). Section 3(11) of the bill as presented to the Senate provided:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire contract of purchase, *attempt or offer to acquire or solicitation of any offer to sell a security or any interest in a security.*" (Emphasis added)

And Section 3(12) of the bill provided:

"The terms 'sale' and 'sell' each include any contract of sale or disposition of, contract to sell or dispose of, *attempt or offer to dispose of, or solicitation of an offer to buy a security or any interest therein.*" (Emphasis added)

During consideration of the bill on the Senate floor, the ambit of these provisions was narrowed through amendment into the present wording of §§ 3(a)(13) and (14). 48 Stat. 884 • • •"

As the pledgor is not a seller, similarly the pledgee, who receives corporate securities as security for a loan is not a purchaser within the statutory definition.

When Congress wanted to include a "pledge" within the definition of "sale" it did so. Thus in the Public Utility Holding Company Act, Congress defined "sale" or "sell" to include "any sale, disposition by lease, exchange or pledge, or other disposition." 15 U.S.C. Section 79b (a)(23). In this case by not including "a pledge" within the statutory definition of the 1934 Act, Congress did not intend to include a pledge for purposes of a civil damage action under Section 10(b) or Rule 10b-5 of the 1934 Securities and Exchange Act.[11]

See *McClure* v. *First National Bank of Lubbock,* 497 F.2d 490 (CA 5 1974) *cert. denied* 420 U.S. 930 (1975). In that case, the plaintiff sued a bank and its loan officer on a securities fraud theory in connection with a stock transaction which arose when, as part of a loan, the bank required plaintiff to pledge her stock as collateral. Thereafter, the bank foreclosed on the loan and liquidated the

[11] The District Court stated in *McClure* v. *First National Bank of Lubbock,* 352 F. Supp. 454, 458 (N.D. Texas 1973); "It is significant that Congress has in effect found, by the passage of the Truth in Lending Act, 15 U.S.C. § 1601 et seq., that the Securities Exchange Act of 1934 is inapplicable to consumer loans, and, by strong implication, to commercial loans as well. Congress apparently felt it necessary to curb abuses in consumer loans by the passage of a new statute, thus implying that such abuses could not be reached by the Securities Exchange Act of 1934. And in 15 U.S.C. § 1603, a section within the Truth in Lending Act, Congress in setting forth transactions outside the purview of the Truth in Lending Act lists 'credit transactions . . . for business or commercial purposes' and 'transactions in securities' as two different types of transactions. Thus it is clear that most, if not all, ordinary commercial loans are not 'securities' as defined by Congress as recently as 1968. Should Congress wish to place such commercial loans under federal regulation, it need only enact a statute similar in form to the Truth in Lending Act. It is not within the proper province of this Court to extend the scope of the Securities Exchange Act of 1934 beyond the point where Congress has chosen to act."

assets of the corporation rendering plaintiff's stock worthless.

The District Court dismissed the complaint on the grounds of lack of subject matter jurisdiction. The Court of Appeals affirmed the lower court's ruling that the transaction did not fall within the federal securities laws.

As in *McClure supra,* Judge Pollack noted "there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, • • •. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize that transaction as a purchase of the stock by plaintiffs are not convincing" (A.134).

The underlying obligation between Mallis and Kupferman and Arnold and Fowler was not the purchase of the Equity National stock, but the agreement between them whereby Mallis and Kupferman were to make "a short term loan" of $156,000 to Arnold and Fowler for which they were to receive $50,000 in interest[12] within thirty (30) days (A.156, 16, 49). The Equity National stock was collateral for the entire transaction. Moreover, by their own allegations, Mallis and Kupferman did not expect to be repaid from the Equity National stock, but from the proceeds of another transaction (A.49). Mallis and Kupferman

[12] $50,000 interest for a thirty (30) day use of money is arithmetically computed to be an interest rate of 383%. Regardless of whether Mallis and Kupferman called the $50,000 "profit" "bonus" "finders' fee" or "plain interest", $50,000 to be received for a short term thirty day loan of $156,000 is usurious interest. See *Durst* v. *Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, 354 (1st Dep't 1964), affirmed 17 N.Y. 2d 445, 266 N.Y.S.2d 806 (1965) where now Chief Judge Breitel ruled that a purported stock sale transaction could be a disguise for a usurious loan agreement, "regardless of the form". See also *Schwartz* v. *Userowitz,* 56 Misc. 2d 1016, 290 N.Y.S.2d 12 (S.Ct. N.Y. 1968) affirmed 31 A.D. 2d 1010, 299 N.Y.S.2d 781 (1st Dep't, 1969) all monies exacted as "interest" or "bonus" were subject to the usury laws.

clearly did not enter into "a contract to buy, purchase or otherwise acquire" securities as required by the Act (15 U.S.C. Section 78c(a)(13)).

Mallis and Kupferman merely acquired a security interest in the stock which, under New York law in any event, was rendered totally unenforceable by virtue of their participation in a usurious contract when they charged 383% interest. This was plainly in excess of the rate allowed under Section 5-501 of the N.Y. General Obligations Law.

Section 190.40 of the N. Y. Penal Law declares criminally usurious interest, "at a rate exceeding twenty-five percentum per annum . . .". Section 5-511 of the N. Y. General Obligations Law voids and renders unenforceable the usurious contract.[13]

Totally ignoring the language of the 1934 Act, and the fact that Mallis and Kupferman, as pledgees, merely had a security interest in the collateral subject to divestment, the court of appeals erroneously relied on two of its earlier decisions construing the 1933 Securities Act to expand liability under Section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act, *United States* v. *Gentile,* 530 F.2d 461 (C.A.2, 1976) cert. denied 426 U.S. 936 (1976), *SEC* v. *Guild Films,* 279 F.2d 485 (C.A.2, 1960) cert. denied sub nom. *Santa Monica Bank* v. *SEC,* 364 U.S. 819, which had previously stated that all pledges were sales. *Guild*

[13] Section 5-511(2) of the N.Y. General Obligations Law further provides that where, as here, a pledge "has been taken or received; in violation . . . of the (usury) provisions, the court shall declare the same to be void and order the pledge to be surrendered and cancelled." Certainly Mallis and Kupferman did not by the acceptance of the pledge, purchase the Equity securities, but obtained a security interest rendered void by virtue of the fact that they had entered into a plainly usurious agreement, and under New York Law, the Courts would require them to surrender and return the pledged stock certificates to Arnold and Fowler. See *Curtiss* v. *Teller,* 157 App. Div. 804, 143 N.Y.S. 188 (4th Dep't, 1913). *Bowery Savings Bank* v. *Nirenstein,* 269 N.Y. 259, 263, 199 N.E. 211 (1935).

Films involved a scheme where a bank and its debtor agreed to liquidate unregistered securities as soon as the securities were received to satisfy an outstanding indebtedness. The court held the pledge to be a sale and the bank an underwriter within the meaning of the 1933 Act. In *Gentile,* the Second Circuit held that a pledge of fraudulent securities to borrow moneys was a sufficient sale of securities to subject the fraudulent pledgor to criminal violations. The pledgor there had issued unauthorized certificates in his own name and either sold them on the over the counter market or pledged them to banks as collateral for loans which they had no intention of repaying (530 F.2d at 464). In that context, the court held that the pledge of securities was a sale relying on the *Guild Films* decision, and disagreeing with the Fifth Circuit decision in *McClure* (530 F.2d at 466-467). Both cases arose under the 1933 Securities Act and rely on the broader definition of "purchase" and "sale" in that Act, rather than the more narrow definition in the 1934 Act. See *Blue Chip Stamps supra* at 733, n.5. Unlike the instant civil action, both cases involved the enforcement of the Securities laws, whether injunctive relief in *Guild Films supra* or criminal proceeding in *Gentile supra. Guild Films* has been broadly criticized by the commentators as wrongly decided. See 1 Loss, *Securities Regulation* 2d Ed. 1961, 645-649, Pierce, *Securities and Exchange Commission* v. *Guild Films Co.,* 1961 Business Lawyer April, 604.

Although we do not believe a pledge is a "purchase" or "sale" for purposes of the 1933 Securities Act, it plainly was not intended to be a "purchase" or "sale" for

[14] Mr. Justice Goldberg in *SEC* v. *Capital Gains,* 375 U.S. 180, 193 noted, "it is not necessary in a suit for equitable relief to establish all the relevant requirements as in a suit for money damages." See also *Blue Chip Stamps Inc.,* 421 U.S. at 751, n.14 where this Court stated "Our decision in *SEC* v. *National Industries,* 393 U.S. 453 (1969), established that the 'purchaser-seller rule imposes no limitations on the standing of the SEC to bring an action for injunctive relief under § 10(b) and Rule 10(b)(5).'"

purposes of a civil action under the 1934 Securities Exchange Act. As Professor Loss points out, "federal legislation was hardly needed for privately negotiated pledge transactions between borrowers and lenders." 1 Loss, *Securities Regulation* (2d Ed. 1961) 649.

The Rules of the Securities and Exchange Commission under the 1934 Act recognize that a pledge of securities is not a sale. See Rule 16-a-6, 17 C.F.R. Section 240.16a-6(2) which requires that the pledgor, not the pledgee, make the requisite filings reflecting "change in beneficial ownership."

Similarly during the 27 years between the passage of the Securities Act of 1933 and the second circuit's decision in *Guild Films,* the SEC took the position that a bona fide pledge was not the distribution of securities, and registration was unnecessary.[15]

In reaching its conclusion, the Commission had followed the views of two early General Counsels of the Commission[16], Throop and Lane "Some Problems of Exemption

[15] See in *F.L. Jacobs Co.* v. *Inland Credit Corp.*, 57-61 CCH Federal Securities Law Reporter, paragraph 90,908 (S.D.N.Y. 1959) a suit seeking to void a loan transaction and to enjoin the defendant from exercising the right to enforce an agreement by the sale of plaintiff's collateral security in a corporation. Judge Edelstein ruled: "• • • There is doubt on the question of whether or not this collateral is 'security' under § 2(1) of the Securities Act of 1933 inasmuch as the sale of it can hardly be said to put into the hands of the public anything representing the advance of money upon which they may hope to receive earnings. There is, further, doubt on the issue of whether or not a sale of collateral by a bona fide pledgee (and there is nothing in this record to indicate that the defendant is anything but a bona fide pledgee) can result in any liability to the pledgor or pledgee. No reported cases on this point have been discovered by the court or cited by counsel, but the affirmative of the proposition seems highly tenuous, the more so because of the absence of precedent in the context of long settled commercial practices."

[16] Note, "The Exception Status Of The Bona Fide Pledgee of Unregistered Securities Under the Securities Act of 1933," 1960 Duke Law Journal 638, at 641, n.10.

under the Securities Act of 1933," 4 Law and Contemporary Problems 89, 124-125, Note 103.

When *Guild Films* was handed down, the SEC, although it continued to recognize that a bona fide pledge of collateral in good faith was exempt from the distribution requirements[17], changed its position to hold that the pledge of unregistered stock as loan collateral becomes a "sale" only if the pledgee accepts the securities with the knowledge that it is going to foreclose on the securities and to distribute the securities to the public at large. Professor Loss pointed out (1 Loss ibid. at 645) that the status of the foreclosure sales by pledgees "was unsettled by the Second Circuit decision of May, 1960 in the *Guild Films* case." Until then it had been generally considered that "a bona fide pledge [as here where it had taken *place two years before*] *did not involve* an 'offer' or 'sale' and that, in any event, a foreclosure sale by a bona fide pledgee of securities deposited as collateral • • • was exempt" under the law (Loss, ibid.). Despite its position with respect to registration requirements and distribution under *Guild Films* the Securities and Exchange Commission has recognized that (Release No. 4669, Securities Act of 1933, February 17, 1964, Emphasis added):

> "Since a sale by the pledgee is for the purpose of fulfilling certain obligations of the pledgor, since the pledgee is obligated to remit to the pledgor receipts from such sale in excess of the amount of the obliga-

[17] In 73-74 CCH Federal Securities Law Reporter Paragraph 83,361, the Commission Staff stated: "It is anticipated that the Japanese Purchasers will pledge their shares to secure bank loans, the proceeds of which will be used to purchase the Company's stock. The lending institutions involved are permitted to dispose of the shares in the event that the Japanese Purchasers default on their repayment of the loans. You state that you do not consider the resale potential as a significant factor since the size and prominence of the Japanese Purchasers make it highly unlikely that they would default on their repayment obligations."

tion, and since *the pledgee, in effect, stands in the shoes of and acts for the pledgor in selling the collateral,* a broker may ordinarily effect sales as agent for both parties, if he takes into account other sales by the pledgor and his associates within the preceding six months, and otherwise complies with the rule."

To the same effect see *Great Southwestern Corp.*, 70-71 CCH Federal Securities Law Reporter, paragraph 78, 132 (April 13, 1971); *Air Reduction Company Incorporated,* 70-71 CCH Federal Securities Law Reporter, paragraph 78,101 (April 8, 1971). The conclusion by the court below that the pledge of the collateral by Arnold to Mallis and Kupferman is a sale is contrary to the plain language of the Act and common law and the SEC's recognition that at the time of the pledge, title does not pass to the pledgee, but the pledgee merely "stands in the shoes of" the pledgor, *supra.*

The Second Circuit attempted to limit the decision in *Blue Chip Stamps* and to stress the fact that the pledge to Mallis and Kupferman "is just as concrete a transaction as is a normal transfer of title." (A. 164). However, this court made it clear in *Blue Chip Stamps* that the term "sale" was not intended to apply to a "generalized event of public disposal of property, but was carefully drawn to define the term 'sale' for purposes of the Act" (421 U.S. at 733, n.5). A pledge plainly does not come within this definition. *Herpich* v. *Wallace,* 430 F.2d 792, 812 (CA 5, 1970) cited with approval by this Court in *Blue Chip Stamps,* 421 U.S. at 748.

C. The mere acceptance of a pledge of stock as collateral for a loan in 1970 and its subsequent release to the borrower upon the repayment of the loan in 1972, did not make Bankers Trust a "seller" of securities subject to a civil damage action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

In holding that Bankers Trust was a "seller" of securities by virtue of its release of the collateral to the Kateses, the court of appeals compounded its error by deciding an issue totally unnecessary to its decision. As this court recognized in *Blue Chip Stamps,* the "purchase or sale" requirement of Section 10(b) and Rule 10b-5 is a purchase or sale by plaintiff—not by the defendant. In any event for the very same reasons *supra* that a pledge of stock by Arnold to Mallis and Kupferman was not a purchase, so the return of the pledged securities to the Kateses upon repayment of the indebtedness to Bankers Trust was not a sale.

As we have shown, *supra,* the pledge of stock both at common law and under the Uniform Commercial Code was not a sale of securities but merely the delivery of a "security interest" in the collateral to the creditor. The underlying obligation of Kates to Bankers Trust was a note, *not* the securities. Upon repayment of the indebtedness, Bankers Trust was required to return the collateral to the Kateses (U.C.C. Section 9-506). Such return to the pledgor did not bring the transaction within the purchase or sale requirements of Section 10(b) and Rule 10b-5.

The conclusion by the court below that Bankers Trust became a "seller" of the collateral when it returned the securities to the Kateses is contrary to the plain language of the Act, the common law and the SEC's recognition that the pledgor retains an interest in the securities, *supra.* The Kateses did not purchase the stock nor did they anticipate a purchase of their own stock when they repaid the

loan. They merely obtained that to which they were entitled. *See King* v. *Sharp*, 74-75 CCH Federal Securities Law Reporter paragraph 94,828 (Northern District, Texas May 1, 1974) where the court held that the Trustee in Bankruptcy was not a purchaser of securities to sustain standing in a 10(b) and 10b-5 action when the stock previously pledged as collateral had been released by a bank on repayment of the loan. *Cf. Bronner* v. *Goldman*, 361 F.2d 759, 762 (CA 1, 1966), where the court rejected the contention that an action under 10(b) could be brought against a factor who accepted securities as collateral, noting that "their business was lending money and not trading in securities."[18]

In lending money, Bankers Trust makes a credit decision, based on criteria of creditworthiness, whether such loans are secured or unsecured. Banks do not lend money with a view to placing a defaulted loan on their books. Collateral is taken as insurance against the unexpected event of default, just as a person insures his or her house against contingency of fire. *Pierce, "Securities and Exchange Commission* v. *Guild Films Co., Inc.".* 1961 Business Lawyer, April, 603-604.

Loans collateralized by stocks or bonds and regulated by state law are looked upon with favor by banks since the collateral is an additional assurance of repayment. The borrower often benefits from the lender's assurance by being able to obtain funds on more favorable terms then if the transaction were unsecured. These pledges are attractive to borrowers not only in connection with their other

[18] See also *First Trust and Savings Bank* v. *Fidelity Philadelphia Trust Co.*, 214 F.2d 320, 323 (CA 3, 1954), where the court held that a bank which takes documents as a bailment for its customer and then releases documents to a third party did not make the bank a seller within the terms of the Securities Act of 1933.

transactions, but also in connection with the need for funds for personal and business purposes."[19]

The commentators have noted from experience that the pledgee of securities "ordinarily acts on the belief that the odds are highly against his ever having to liquidate the loan by carrying out a sale of the securities so pledged. Indeed, few bankers would want to go into a transaction believing that they would probably have to carry out the sale of the underlying securities." *Vagts supra* at p. 1510. See also Pierce, *supra* at 604-606.

Bankers Trust made an ordinary commercial secured loan to the Kateses. It expected to be, and was, repaid by the debtor almost two years later. The occasion at which Bankers Trust returned the collateral, as required by state law, was a routine closing. The return of the stock to the pledgor upon repayment of the indebtedness does not bring the transaction within the purchase or sale requirement of Section 10(b) and Rule 10b-5. As reported in *McClure* v. *First National Bank of Lubbock, Texas, supra*, (497 F. 2d at 495, emphasis added):

> "• • • A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. A commercial bank's business is lending money not trading in securities. Cf. *Bronner* v. *Goldman*, 361 F.2d 759 (1st Cir.), cert. denied, 385 U.S. 933, 87 S.Ct. 295, 17 L.Ed.2d 214 (1966)

[19] *Coogan, Hogan & Vagts*, 1A Secured Transaction under the Uniform Commercial Code (Matthew Bender)—Vagts, "Pledges of Corporate Securities" at 1502. The importance of the pledge of stocks and bonds as collateral is represented by the survey conducted by the Federal Reserve System for the Special Study of Securities Markets on September 26, 1962, which concluded that "member banks of the Federal Reserve System had outstanding almost $11 Billion of loans wholly or partly collateralized by stocks or bonds".

(factor selling pledged stock not a 'broker' or 'dealer'). If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, *but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview.* See 1 L.Loss, Securities Regulation 649 (2d ed. 1961)."

This reasoning is consistent with this Court's recent ruling in *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 157, where this Court noted the Securities Exchange Act of 1934, "was enacted primarily to halt securities fraud, not to regulate banks. Indeed, banks were specifically exempted from any provisions of the securities laws, and Congress almost contemporaneously enacted other specific legislation dealing with the problems arising from banks' involvement in the securities business. The passage of that legislation and the exemption of national banks from important provisions of the securities laws suggest, if anything, that Congress was reaffirming its view that national banks should be regulated separately by specific legislation applying only to them." This Court further noted in *Radzanower supra*, 426 U.S. at 155, n.11.

"The legislative history of the Securities Acts does not indicate that Congress considered banks as likely defendants in actions brought under those Acts. While Congress did examine problems stemming from the relationship of banks and the securities business in the early 1930's, see S.Rep. No. 1455, 73d Cong., 2d Sess. (1934) it dealt with those problems in comprehensive legislation dealing only with banks. See Banking Act of 1933, 48 Stat. 162. See generally *Investment Co. Institute* v. *Camp*, 401 U.S. 617."

In enacting the Banking Laws, Congress recognized the importance of preserving the financial integrity of banks and subjected the commercial banking business to extensive Federal and State regulation in order to protect the depositors. *United States* v. *Marine Bank Corp.*, 418 U.S. 502, 627, 632.

Aware of the peculiar problems and strength of banks resulting from regulation by state and federal banking authorities, Congress did not seek to make a wholesale application of the securities laws to banks, but instead made specific provisions applicable to banks with respect to the Securities Laws. When Congress concerned itself in the Securities Exchange Act of 1934 with the problems of speculative trading in securities, Congress provided that banks were to be regulated *not* by the Securities Exchange Commission, but by the Federal Reserve Board (15 U.S.C. Sec. 78g-78h).

If Congress in enacting the Securities Exchange Act had intended all transactions involving the pledge of stock to come within the Act and not be governed by state law, it would have said so. The mere fact that securities are involved in the transaction does not automatically bring the transaction within the standing requirements of Section 10(b) and Rule 10b-5 and permit the action to be brought in Federal Court. See *United Housing Foundation* v. *Foreman*, 421 U.S. 837, 849 (1975) footnote 14, where this Court reversed the Second Circuit's expanded and "literal approach" to the Act by noting the Fifth Circuit's decision in *McClure*. Certainly Congress did not intend to federalize the substantive law involving the pledge of stock as collateral merely because the transaction involved securities where, as here, "'the cause of action was one traditionally relegated to state law. . . .'" See *Piper* v. *Chris-Craft Industries, Inc.*, 97 S. Ct. 926, 929 quoting *Cort* v. *Ash*, 422 U.S. 66, 78, *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. ——, 97 S. Ct. 1292, 1303.

In enacting the Securities Exchange Act of 1934, Congress stated that its purpose was to provide for the regulation of "securities exchanges and over-the-counter markets" operating in interstate and foreign commerce and through the mails to prevent inequitable and unfair practices on such exchange. 15 U.S.C. § 78b, 48 Stat. 881 as amended. Congress did not intend to include ordinary commercial transactions involving stock under the umbrella of the act, especially as here where Congress did not expressly provide a private cause of action for violations of Section 10(b). *Santa Fe Industries* v. *Green, supra,* 97 S. Ct. at 1303, the plaintiffs and "others in [their] situation [should be relegated] to whatever remedy is created by state law."

Indeed if every case involving the pledge of securities would come within the Act, the Federal Courts would be burdened by a plethora of litigation involving the debtor and the bank when the loan goes bad and the debtor has pledged securities which are either sold or diminished in value as a result of shifts in the stock market.[20] In an attempt to stave off repayment, the disgruntled borrower-pledgor will institute frivolous actions in federal courts and utilize the extensive discovery available under federal law to harass and annoy the creditor. *Santa Fe Industries, supra,* 97 S. Ct. at 1303, *Blue Chip Stamps, supra,* 421 U.S. at 740. See for e.g. *Dopp* v. *Franklin National Bank,* 374 F. Supp. 904 (S.D.N.Y.) on remand from 461 F.2d 873 (CA 2, 1973) where, after the bank had obtained a judgment

[20] See *Brodheim* v. *Chase Manhattan Bank,* 75 Misc. 2d 394, 347 N.Y.S.2d 394 (Sup. Ct. N.Y. 1973); *American Bank and Trust Company* v. *Lichtenstein,* 45 A.D.2d 790, 369 N.Y.S.2d 155 (1st Dept. 1975); *Smith* v. *Security National Bank,* 175 N.Y.L.J. p. 7, col. 1, and *Grace* v. *Sterling Grace & Co.,* 30 A.D.2d 61, 289 N.Y.S.2d 632 (1st Dep't 1968); *Bankers Trust Company* v. *Ungar,* 387 N.Y.S.2d 813 (1st Dept. 1976); *Bankers Trust Company* v. *Bennett,* 387 N.Y.S.2d 813 (1st Dept. 1976).

against Dopp for non-payment of a note in state court, Dopp instituted an action under Section 10(b) and Rule 10b-5 to prevent Franklin from liquidating pledged collateral to satisfy the judgment. Only after much expensive litigation was the bank allowed to liquidate the collateral and satisfy the judgment, and the action was discontinued as against the bank.

II. Bankers Trust's release of a pledge of collateral to the original borrowers upon repayment of the indebtedness was not "in connection with" the loan transactions between plaintiffs and third parties.

There is still a second basis for ruling that the plaintiffs have failed to state an actionable claim under Section 10(b) and Rule 10b-5. Not only must the plaintiff be a purchaser or seller of securities, but the alleged fraud must be "in connection with" the purchase or sale. The factual matrix of this case plainly does not satisfy the "in connection with" requirement.

Despite the fact that there was and could be no allegation of a fraudulent act by Bankers Trust "in connection with" the pledge of the collateral from Arnold to Mallis and Kupferman, the court of appeals "badly strained" the language of the Act to permit a cause of action under the Securities Exchange Act merely because stock which had been pledged almost two years earlier as collateral in a commercial loan transaction, was redeemed by the pledgor, *i.e.* Kates, who sold it to a third-party, *i.e.* Arnold and Fowler, who then proceeded to pledge it as collateral to a fourth-party Mallis and Kupferman of whose existence Bankers Trust did not know. A plaintiff certainly does not have standing on the mere allegation that the defendant defrauded someone else, such as a third-party purchaser or seller in a separate transaction.

As we have shown *supra* pp. 27-33 Bankers Trust plainly did not sell the stock but merely returned the stock to the pledgor as it was obligated to do upon the repayment of the indebtedness. Similarly, as we have shown, *supra*, Mallis and Kupferman did not purchase the stock when they accepted the Equity National stock for collateral. Moreover, Mallis and Kupferman looked not to the Equity National stock for repayment, but to the proceeds of yet another transaction, *i.e.* the sale of "a block of 100,000 shares of Merck & Co., Inc." (A.49) another transaction of which Bankers Trust was not aware. Certainly, as noted by the State Supreme Court in holding that Mallis had no cause of action against Bankers Trust, since not only was he "not even a purchaser of the shares" but Bankers Trust "could not and did not know of his existence prior to the closing which he did not attend" (A.90).[21] The presence of Bankers Trust and its attorneys at the closing cannot be said to have caused Mallis and Kupferman to enter into the transaction whereby they loaned money to Arnold and

[21] Not only did the pleadings as amplified by the affidavits demonstrate the "lack of nexus" between Mallis and Kupferman and Bankers Trust necessary to bring a 10(b) action but the question was expressly resolved against them by Justice Nadel in the State Court action from which no appeal was taken. Mallis is attempting to relitigate the very same issue in the very same transaction in Federal Courts. This issue is barred by "collateral estoppel". Although the Court of Appeals did not resolve this question and reserved the matter for trial (A.165, Footnote 12), other Federal Courts have held that a state court determination on issues could be given collateral estoppel effect with respect to the same issues in a federal securities case arising under the 1934 Act. *McNally* v. *Esmark*, CCH Federal Securities Law Reporter, Paragraph 96,071 at p. 91, 819 (N.D. Ill. 1977) citing *inter alia Clark* v. *Watchie*, 513 F.2d 994 (CA 9 1975) *cert. denied* 423 U.S. 841 (1976); *Abramson* v. *Penwood Investment Corp.*, 392 F. 2d 759 (C.A. 2, 1968). *McNally* relied on Section 68 of Restatement of Judgments 2d. and held that such findings which were neceessary to the prior judgments are plainly binding in a securities action, and thus plaintiffs were precluded from pursuing their securities law claim.

Fowler collateralized by the Equity National stock. The agreement between Arnold, Fowler and Kates had been consummated on February 24, more than one week before the closing. Mallis and Kupferman had likewise entered into the agreement between Arnold and Fowler to make a loan collateralized by the Equity National stock before the closing. Mallis and Kupferman admittedly did not contact Bankers Trust and cannot be said to have relied upon any representations or misrepresentations of Bankers Trust prior to their agreement. All that Bankers Trust and its attorney did, was upon repayment of its indebtedness, release to its borrower the collateral which had been previously pledged. By that time all of the agreements had been fully negotiated. Mallis and Kupferman had signed the notes. The closing was a mere formality. There was plainly no "nexus" between Bankers Trust's release of the collateral and the pledge of the collateral to plaintiffs by Arnold. See *Tully* v. *Mott Supermarkets*, 540 F.2d 187 (C.A. 3, 1976), *Ketchum* v. *Green*, —— F.2d ——, unofficially reported at CCH Federal Securities Law Reporter Paragraph 96,107 (C.A. 3, 1977) where the court ruled that "the deceptive practices" in which the defendant had engaged and "the ultimate sale" of securities were "not tied sufficiently tightly so as to surmount the 'connection' requirement of § 10(b) . . ."

The crux of the complaint is that Bankers Trust's attorney should have advised plaintiffs at the closing that there were problems with the pledged stock (A.71-72, 79-80). But plaintiffs did not attend the closing. Although the courts below assumed that Bankers Trust and its attorney made affirmative misrepresentations at the closing (A.135, 159), Mallis in his complaint in the state court proceeding sworn to on December 6, 1972 expressly stated that Bankers Trust and its attorney made no representations, but "silently and without disclosure" permitted Kates to deliver a false affidavit to Arnold and "made no effort to inform" Arnold of the falsity of such statement (A.75-76). It was

only after it became apparent that the action against Bankers Trust could not stand under § 10(b) that Mallis and Kupferman asserted for the first time on May 14, 1975 that Bankers Trust "withheld vitally material information from us" and "as we are informed, actually misrepresented that the securities in question were genuine when in fact they were not not" (A.110).

In this case, as in *Amend* v. *Hurley*, 293 N.Y. 96, 59 N.E. 2d 419 (1944), Mallis was represented by his own attorney Arnold (A.71-72, 79-80). As stated by the Court of Appeals in *Amend* v. *Hurley*, 293 N.Y. at 596 "it is not fraud for one party to say nothing on the subject where no confidential or fiduciary relation exists, and where no false statements or acts to mislead the others are made".[9]

A pledgee has no greater duty to speak to an unknown third party under the securities law than it does under state law. See *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 98-99 (C,A. 5, 1975), where the court ruled that a bank acting in accordance with its legal obligation to a pledgor has no duty of disclosure to pledgor's business associate.

There is no contention anywhere in the record that Mallis and Kupferman sought advice from Bankers Trust. Bankers Trust had no knowledge of the agreement entered into between Kateses, Arnold, Fowler and especially not with Mallis and Kupferman. Bankers Trust did not know and could not know the details of the negotiations by which Mallis and Kupferman loaned money to Arnold and Fowler.

[9] In following *Amend* v. *Hurley*, Justice Nadel was consistent with the decisions of other courts such as California where the Supreme Court in *Goodman* v. *Kennedy*, 18 Cal. 3rd 335, 345-348, 134 Cal. Rptr. 375, 382-383, 556 P. 2d 737 (1976), held in a similar situation, that an attorney was not liable for failing to disclose facts which might indicate the possibility of such adverse consequences on sale of securities to the plaintiff's attorney in conversations discussing the proposed sale.

See *Hirsch* v. *DuPont*, 553 F.2d 750, 759-763 (CA 2, 1977) where Judge Kaufman commented that "the securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information". See also *Murphy* v. *McDonnell & Co.*, 553 F.2d 292, 296 (C.A. 2, 1977).

Mallis and Kupferman are seeking to impose upon banks, such as is Bankers Trust, a duty to police the dealings of customers merely because the collateral pledged is stock and not an automobile or accounts receivable. If banks were to become legally responsible for the adequacy and accuracy of their debtors' statements to others, they would be driven to assume an impossible role in monitoring the debtors' transactions with others whenever the collateral for an indebtedness constitutes securities. A bank, whether large or small, is ill-suited to absorb substantial liability arising out of possible securities law violations by its borrowers, the extent and magnitude of which will have no reasonable relationship to—and may substantially exceed—the amount of the loan made.

In instituting this action against Bankers Trust, Mallis and Kupferman are seeking to shift the burden of the loss which may have resulted from their dealings with Arnold, Fowler and Kates to Bankers Trust, which was completely unaware of the underlying transaction.[10]

Certainly the facts of this case did not satisfy the nexus requirement of the statute. As correctly stated by Judge Pollack (A.134) "Plaintiff loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in

[10] As noted *supra*, the state court actions against Arnold, Fowler and Kates in which Bankers Trust is a third party defendant are still pending.

question. While the stock later came into plaintiff's possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus . . .. To allow persons in plaintiffs situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under that rule to an extent uncalled for by the words of the rule or the statute."

Conclusion

When Congress enacted the Securities Exchange Act of 1934, Congress did not intend that a bank such as Bankers Trust should be potentially liable under Section 10(b) and Rule 10b-5 whenever it releases collateral to a borrower who engages in securities transactions with third parties, of which the bank is totally unaware. While Congress did not exempt banks from liability under 10(b), Congress recognized that banks should have the same protection afforded other potential defendants, including the requirement that the plaintiff be a purchaser or seller "in connection with" a sale of securities.

The very same Congress which sought to protect the financial integrity of the banking system by regulating the margin purchases of securities through the Federal Reserve Board did not seek to extend banks' liability to unknown third parties engaging in securities transactions over which banks have no control. The financial integrity of banks would be exposed far beyond what banks intended when they made the loan to their customer. Congress certainly did not intend to submit banks to any greater liability and potential strike suits and vexatious litigation than it did other corporate defendants as set forth in *Blue Chip Stamps*. See 421 U.S. at 742-749.

For these reasons the judgment of the Court of Appeals should be reversed, and the judgment of the District Court dismissing the complaint against Bankers Trust Company should be reinstated.

Respectfully submitted,

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August 18, 1977

STATUTORY APPENDIX

Statutes Involved

Section 3(a) of the Securities Exchange Act of 1934, 15 USC § 78c(a), as amended provides in relevant part:

• • •

"(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.

(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

• • •

Section 10 of the Securities Exchange Act of 1934, 15 USC § 78j, 48 Stat. 891, as amended, provides in relevant part:

"It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 CFR (Code of Federal Regulations) § 240.10b-5 provides in relevant part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

• • •

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Penal Law

§ 190.40 Criminal usury

A person is guilty of criminal usury when, not being authorized or permitted by law to do so, he knowingly charges, takes or receives any money or other property as interest on the loan or forbearance of any money or other property, at a rate exceeding twenty-five percentum per annum or the equivalent rate for a longer or shorter period.

• • •

The Uniform Commercial Code, as enacted in New York, provides in relevant part.

§ 9-305. When Possession by Secured Party Perfects Security Interest Without Filing

A security interest in letters of credit and advices of credit (Subsection (2) (a) of Section 5—116), goods, instruments, negotiable documents or chattel paper may be perfected by the secured party's taking possession of the collateral. If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest. A se-

curity interest is perfected by possession from the time possession is taken without relation back and continues only so long as possession is retained, unless otherwise specified in this Article. The security interest may be otherwise perfected as provided in this Article before or after the period of possession by the secured party.

§ 9-501. Default; Procedure When Security Agreement Covers Both Real and Personal Property

(1) When a debtor is in default under a security agreement, a secured party has the rights and remedies provided in this Part and except as limited by subsection (3) those provided in the security agreement. He may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure. If the collateral is documents the secured party may proceed either as to the documents or as to the goods covered thereby. A secured party in possession has the rights, remedies and duties provided in Section 9—207. The rights and remedies referred to in this subsection are cumulative.

(2) After default, the debtor has the rights and remedies provided in this Part, those provided in the security agreement and those provided in Section 9—207.

• • •

§ 9-502. Collection Rights of Secured Party

• • •

(2) A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who undertakes to collect from the account debtors or obligors must proceed in a commercially reasonable manner and may deduct his reasonable expenses of realization from the collections. If

the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency. But, if the underlying transaction was a sale of accounts, contract rights, or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.

• • •

§ 9-504. Secured Party's Right to Dispose of Collateral After Default; Effect of Disposition

(1) A secured party after default may sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing. Any sale of goods is subject to the Article on Sales (Article 2). The proceeds of disposition shall be applied in the order following to

(a) the reasonable expenses of retaking, holding, preparing for sale, selling, leasing and the like and, to the extent provided for in the agreement and not prohibited by law, the reasonable attorneys' fees and legal expenses incurred by the secured party;

(b) the satisfaction of indebtedness secured by the security interest under which the disposition is made;

(c) the satisfaction of indebtedness secured by any subordinate security interest in the collateral if written notification of demand therefor is received before distribution of the proceeds is completed, but only to the extent of the proceeds undistributed when such notification is received. If requested by the secured party, the holder of a sub-

ordinate security interest must seasonably furnish reasonable proof of his interest, file with the secured party a sufficient indemnity bond, and satisfy any other reasonable requirements imposed by the secured party, and unless he does so, the secured party need not comply with his demand.

(2) If the security interest secures an indebtedness, the secured party must account to the debtor for any surplus, and, unless otherwise agreed, the debtor is liable for any deficiency.

• • •

(3) Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended dispostion is to be made shall be sent by the secured party to the debtor, and except in the case of consumer goods to any other person who has a security interest in the collateral and who has duly filed a financing statement indexed in the name of the debtor in this state. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale.

(4) When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for

value all of the debtor's rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto. The purchaser takes free of all such rights and interests even though the secured party fails to comply with the requirements of this Part or of any judicial proceedings

(a) in the case of a public sale, if the purchaser has no knowledge of any defects in the sale and if he does not buy in collusion with the secured party, other bidders or the person conducting the sale; or

(b) in any other case, if the purchaser acts in good faith.

• • •

§ 9-506. Debtor's Right to Redeem Collateral

At any time before the secured party has disposed of collateral or entered into a contract for its disposition under Section 9—504 or before the obligation has been discharged under Section 9—505(2) the debtor or any other secured party may unless otherwise agreed in writing after default redeem the collateral by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party in retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorneys' fees and legal expenses.

§ 9-507. Secured Party's Liability for Failure to Comply With This Part

(1) If it is established that the secured party is not proceeding in accordance with the provisions of this Part disposition may be ordered or restrained on appropriate

terms and conditions. If the disposition has occurred the debtor or any person entitled to notification or whose security interest has been made known to the secured party prior to the disposition has a right to recover from the secured party any loss caused by a failure to comply with the provisions of this Part.

• • •

APPENDIX

Letterhead of Helfand, Lesser, Moriber & Feldman.

August 25, 1970

Mr. Philip Greene
Bankers Trust Co.
85 Delancey Street
New York, New York

Dear Mr. Greene:

Our client, Mr. Jerome B. Kates, has pending before you a request for a loan in the sum of $30,000.00, said loan to be collateralized by approximately 40,000 shares of Equity National Industries, Inc., common stock.

Equity National Industries, Inc. is a conglomerate based in Atlanta, Georgia. Its shares are currently traded over-the-counter, selling at approximately $6.25 bid, and it is listed daily in the Wall Street Journal and the New York Times. Equity National Industries, Inc. has pending an application for listing on the American Stock Exchange and has been informed by the Exchange that it meets all requirements for listing.

Mr. and Mrs. Kates acquired their shares pursuant to an Agreement and Plan of Reorganization dated July 23, 1970 between Equity and Take Two, Inc., a New York corporation of which Mr. Kates is president. A copy of said Agreement is being submitted for your examination.

Under the aforesaid Agreement, the shareholders of Take Two, Inc. are to receive as an original payment in exchange for all of the shares of Take Two, Inc., a maximum of 175,000 shares of Equity provided that Take Two, Inc. shall earn an amount equal to or in excess of $350,000 net before taxes for the calendar year December 31, 1970, and that the net worth of Take Two, Inc. shall be equal

to or in excess of $225,000.00 at December 31, 1970. By reason of the fact that at the time of the closing on August 7, 1970 it was determined that Take Two, Inc. had already earned $130,000.00 pre-tax for the first six months of the calendar year 1970 ending July 30, 1970, 65,000 shares of Equity were delivered to the stockholders of Take Two, Inc. at the closing, the balance of 110,000 shares being held in escrow in accordance with an Escrow Agreement (marked Exhibit "B") dated August 7, 1970, until a determination can be made at the close of the calendar year as to the final net before tax earnings and net worth of Take Two, Inc. for the calendar year ended December 31, 1970. A copy of this Escrow Agreement is submitted herewith for your examination.

The stock certificates of Equity being submitted to you as collateral bear on the back a legend referring to the aforementioned Escrow Agreement. The reason for this being that if the before tax earnings of Take Two, Inc. are less than $350,000.00 for the calendar year 1970 and/or the net worth of Take Two, Inc. is less than $225,000.00 at December 31, 1970, the shareholders of Take Two, Inc. would receive a lesser number of shares than 175,000 shares in accordance with a formula set forth in Paragraph "4" of said Escrow Agreement. Only if Take Two, Inc. were to sustain losses for the last six months of this year in an amount sufficient to eliminate the $130,000.00 previously earned in the first six months of the year, would the stockholders of Take Two, Inc. including Mr. and Mrs. Kates, be required to return any of the 65,000 shares of Equity previously delivered to them at the closing. In this connection we wish to advise you that in addition to the $130,000.00 pre-tax earnings for the first six months, Take Two, Inc. has earned approximately $60,000.00 pre-tax for the period of July and

August, 1970. In addition, the company has recently employed an additional salesman and director, which additions are expected to increase the monthly earnings for the remainder of the year. It is the opinion of management that Take Two, Inc. will have no difficulty in earning the required $350,000.00 pre-tax earnings for this calendar year and will have the required $225,000.00 net worth as of December 31, 1970 which will entitle the shareholders to receive the additional 110,000 shares of Equity now being held in escrow.

In accordance with the Agreement between Equity and Take Two, Inc. the shareholders of Take Two, Inc. shall be entitled to receive in the following four years after December 31, 1970, an amount of shares equal to the total number of shares received at the end of 1970, in accordance with a formula set forth in Paragraph "3", Page 8 of the Agreement. This, therefore, will enable the stockholders to receive a maximum of an additional 175,000 shares or a total of 350,000 shares. Said shares may be received in a lesser period of time than four years, depending upon the earnings of Take Two, Inc.

Mr. Kates was the major stockholder of Take Two, Inc. and as such received approximately 40,000 shares of the 65,000 shares already delivered at the closing. He will receive the same proportion of the 110,000 shares being held in escrow for delivery at the end of this year and will also be entitled to receive the same proportion of the remaining 175,000 shares which may be delivered in the following four years or less.

We wish to further direct your consideration to the provisions of the contract under Paragraph "2", a, b and c, Page 6A, 7 and 8, which provided that Equity shall deliver to the stockholders of Take Two, Inc., an additional 58,000 shares of Equity if the average market price of

Equity common stock shall not exceed $12.00 per share for the month of December, 1971. Said shares have also been placed in escrow pursuant to an Escrow Agreement dated August 7, 1970, a copy of which is submitted to you herewith. Mr. Kates again would be entitled to receive the same proportion of said shares as previously referred to.

It is our opinion that the shares of stock proposed to be delivered to you as collateral by Mr. and Mrs. Kates, although bearing the usual restrictive legend covering unregistered securities, will become eligible for public sale without registration after six months from the date of closing on August 7, 1970, under the provisions of Section 154 of the Securities and Exchange Act as amended, (the so-called 1% rule). There are presently outstanding in excess of 2,000,000 shares of common stock of Equity which would enable Mr. Kates to sell up to 20,000 shares of Equity stock within a six month period. Management and counsel to Equity have concurred in this opinion.

If there is any further information which we can supply which will be of help to you, please feel free to call upon us.

Very truly yours,

ROBERT HELFAND
Robert Helfand

RH:ls

Letterhead of Schwartz, Mermelstein, Burns, Lesser & Jacoby.

April 21, 1971

Bankers Trust Company
85 Delancey Street
New York, New York 10022

Re: Jerome B. Kates—Loan and Collateral Security

Gentlemen:

We represent Mr. Jerome B. Kates and his wife Judith Kates.

We have been advised by our clients that in connection with the loan made by you in September, 1970 to Mr. Kates in the amount of $50,000.00, they delivered to you as collateral security for the loan the following shares of the capital stock of Equity National Industries, Inc. (Equity):

Twenty Nine Thousand Eight Hundred Twenty One (29,821.00) shares issued to Jerome B. Kates, as evidenced by Certificate #U 1833; and,

Ten Thousand Five Hundred Sixty Three (10,563.00) shares issued to Judith Kates, as evidenced by Certificate #U 1828

(The "Securities")

We further understand that you are in receipt of a letter from Equity demanding its prior approval of your disposition of the Securities.

This is to inform you that we have advised our clients that notwithstanding any controversy between Equity and them respecting the conditions of issuance of the Securities, since they delivered them to you as collateral for the

loan they have every right to expect you to return the Securities to them upon repayment of the loan.

This letter is intended to advise you that our clients will hold you fully responsible for any damages which may be sustained by them in the event you fail to return the Securities to them at such time as your loan to Mr. Kates has been repaid.

Very truly yours,

SCHWARTZ, MERMELSTEIN, BURNS, LESSER & JACOBY

By EVERETT A. FROLICH
Everett A. Frohlich

EAF/cg

HAND DELIVERED

May 24, 1971

E. Cooke Rand, Esq.
Weiss, Preston, Rosenthal,
Heller and Schwartz
295 Madison Avenue
New York, New York 10017

Re: Take Two, Inc. and
Jerome and Judith Kates

Dear Mr. Rand:

This is in confirmation of my telephone conversation with you last Friday to the effect that Bankers Trust Company declines to deliver to Equity National Industries, Inc. the Certificates of Stock demanded by your corresponding attorneys of Atlanta, Georgia, in their letter of April 14, 1971, addressed to Bankers Trust Company at 85 Delancey Street, New York, N.Y.

As I explained to you, the above mentioned shares of stock were delivered to the Bank by Jerome B. Kates as collateral security for loans made to him and will be returned to him only when said loans are repaid.

Bankers Trust Company does not intend to get into any dispute that you may have concerning his right to the said shares of stock.

Moreover, the Bank has been put on written notice by the attorneys representing Mr. Kates, not to release the said collateral upon penalty of damages. If your client is disposed to furnishing the Bank with an Indemnity Bond to fully protect the Bank in this matter, we will consider your client's demand. Otherwise, you may consider this letter as a rejection.

Very truly yours,

NATHAN SILVERMAN

NS:am

Supreme Court, U. S.
FILED
SEP 28 1977

In The

Supreme Court of the United States

October Term, 1977

No. 76-1359

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN,

Respondents.

BRIEF FOR RESPONDENTS

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In The

Supreme Court of the United States

October Term, 1977

No.

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN,

Respondents.

BRIEF FOR RESPONDENTS

QUESTIONS PRESENTED

1. May a bank which has a financial interest in what it knows to be worthless stock, participate in a sale thereof, receive at closing a large portion of the consideration paid by an unsuspecting buyer and escape liability under the Federal Anti-Fraud Securities Laws for the damages suffered?

2. May a pledgee of worthless stock, originally believed by him to be valuable, maintain an action for damages under the Federal Anti-Fraud Securities Laws where foreclosure and sale to obtain "standing" is enjoined and in any event such foreclosure and sale would be an empty gesture?

3. Were the respondents in fact or in law "buyers" of stock rather than pledgees; and, on the facts of this case, is there any difference between the two?

THE PROLOGUE TO FRAUD

Prior to August 25, 1970 one Jerome B. Kates applied to Bankers Trust Company (hereinafter "Bankers") for a $50,000 loan offering some 40,000 shares of the stock of Equity National Industries Inc. (hereinafter "Equity") as collateral. Bankers refused to make the loan, absent a letter of opinion from Kates' counsel as to legal matters relating to the stock, because the stock was both unregistered and subject to a condition (A56). The letter was forthcoming (Appendix to Appellants' Brief, pp. 47-50) but expressed an opinion and belief within the ken of accountants or economists or corporate management rather than on legal matters. Nevertheless, the loan was made.[1]

The condition was not met; within about six months from the time the loan was made, and on March 2, 1971, Atlanta, Georgia, counsel to Equity, the issuer, hand-delivered to Bankers' representative in New York a letter advising that the stock was worthless and the return of the certificates was requested (A95, A97). The parties exchanged other correspondence (A95-A100). In February of 1972, Equity filed suit against Bankers seeking a return of the stock.[2] Because the complaint in this case was

1. The condition to valid issuance of the stock was minimum specified earnings of Take Two Inc., a company owned by Kates and acquired by Equity from Kates in consideration for the issuance of the stock. The letter of opinion of counsel expressed confidence that the minimum earnings figure would be met (Appendix to Appellant's Brief, pp. 47-50). Either Bankers did not obtain the extensive litigation record of Kates and his corporations or they chose to ignore it (A145-A153).

2. *Equity National Industries Inc. v. Kates, et al.*, S.D.N.Y. 72 Civ. 503. In his affidavit submitted to the District Court, Silverman of Bankers asserts that Equity discontinued its litigation against Bankers because "Equity was

(Cont'd)

dismissed at the pleading stage by the District Court for respondents' alleged lack of standing, the record fails to disclose the terms under which Kates had agreed to repay the loan since discovery had not commenced prior to dismissal. In an affidavit submitted in the action commenced by respondents herein in the Supreme Court of the State of New York, Jasper, Bankers' loan officer stated that Kates made regular monthly payments in reduction of the loan and the bank therefore "took no action to sell the collateral" (A57). The statement is curious because in July, 1971, Bankers recovered judgment not only against Kates, but his wife as well, for $54,795.25 (A147). The bank failed to foreclose on the collateral, presumably because it was worthless, and the bank knew it, and the record does not suggest any effort to enforce the judgment. The inference is fair that the bank hoped to be made whole by some disposition of the stock other than through formal foreclosure and sale. In the meantime, it is a fair inference that Bankers was pressing Kates for payment.

THE ANATOMY OF THE FRAUD

Arnold was Mallis' lawyer in another matter.[3] Arnold and one Fowler, a stock broker, met Kates (the record does not disclose how or when) and apparently Kates offered to sell them the stock. Arnold and Kates entered into a buy-sell agreement on February 24, 1972 for this utterly worthless stock for a

(Cont'd)

convinced that it had no action against Bankers Trust" (A105). The statement may be literally true because Equity discontinued the suit upon learning that Bankers had disposed of the stock prior to the time an injunction could be obtained. Equity then instituted suit for injunctive relief against Bankers' successor in interest, the respondents here.

3. Mallis was the victim of an earlier stock fraud and engaged Arnold for the purpose of instituting suit to recover his losses. On this basis appellant argues that Mallis was a "sophisticated" buyer (see Appellant's Brief, n.7, p. 8). Respondents, on the other hand, submit that sophisticated investors do not find it necessary to be plaintiffs in successive fraud suits.

consideration of $181,728.00, Kates warranting its genuiness[4] (A23-A25). The agreement refers to the buyer as "Jack Arnold *as attorney*" (italics added).[5]

Arnold and Fowler proceeded to attempt to find the balance of funds required, a sum in excess of $156,000 to close the transaction. Arnold found the respondents, two Long Island dentists, who made the money available by borrowing it from Franklin National Bank. Arnold, the attorney, and Murfitt, a vice president of the Franklin National Bank, who had approved the loan by Franklin to the respondents, attended the closing with Kates on March 2, 1972 at Bankers Trust Company offices as the representatives of respondents. Fowler was also present as was Nathan Silverman, the attorney for Bankers (A59).

The buyer or "buying group" knew that Bankers Trust Company had an interest in the stock because one of the checks delivered at the closing named Bankers as co-payee (A26). Respondents claim Bankers' name was stricken without their authority from the check (A109). Moreover, the closing was held

4. The attention of the Court is invited to ¶ 7 of the buy-sell agreement between Kates and Arnold (A25) which incorporates a "time of the essence" clause. At page 7 of their brief to this Court the statement, not supported by anything in the record, is made that Bankers Trust Company was served with the summons and complaint in the action filed by Equity to obtain cancellation of the certificates on March 10, 1972. It is fair to assume that at least some of the defendants were served during the month of February and that the "time of the essence" clause was intended to conclude the transaction prior to Equity's action proceeding any further. Assuming that Bankers was indeed not served until March 10, 1972, it does not necessarily follow that it was unaware of the institution of the suit some days or weeks previously and on the contrary, it is fair to assume Bankers was advised by Equity weeks prior to the actual date of service that suit was imminent or had been filed. There has been no development thus far of Bankers' involvement, if any, with the "time of the essence" clause.

5. The significance of this description of Arnold is discussed, *infra*, p. 9. Obviously, he signed in a representative capacity.

in the Legal Department offices of Bankers, one of the most prestigious banks in the City of New York if not the United States. Counsel for Bankers states in an affidavit to the Court below that it allowed its offices to be used as a "convenience" (A106) but the fairer inference is that, as in other "closings" where a bank is interested in and required to consummate a transaction, Bankers, which had possession of the securities and an interest therein, insisted that the closing be held in its own Legal Department. It received at that time and place at least $45,000 (A26) in the form of a check of the Franklin National Bank, the funds having been generated by a loan made by respondents from Franklin National Bank.

Bankers' surrender of these securities on receipt of a large portion of the purchase money in this setting, with its attorney present, gave to the transaction an air of propriety that could hardly be duplicated. This air was fortified by the fact that in the face of the warnings contained on the endorsement side of the certificates that they could not be "sold, transferred, pledged or hypothecated . . ." the bank had accepted their pledge and by the silence of its attorney and by his presence at the sale of the stock the bank in effect certified that it was satisfied in having accepted the securities as collateral; why should the buyer have been wary of treading a path previously tread without mishap by this prestigious bank? Finally, the Kates affidavit (A84) which was sworn to on the date of the closing was apparently requested at the closing by the buyer or his representatives and the same must have been prepared for Kates' signature by a secretary employed in the office of Bankers' Legal Department under the direction of Bankers' lawyer.

Respondents' $156,000 having been divided between Bankers and Kates for the relinquishment of their respective interests in utterly worthless stock, they soon thereafter learned of their plight and were ultimately named as defendants, together with Kates, in an action commenced by Equity in the Delaware Chancery Court (A42-A46) which sought an

adjudication that the stock was worthless and an injunction against further transfer. This relief was apparently granted.

ARGUMENT

INTRODUCTION

A mere recitation of the events giving rise to this litigation is enough to demonstrate that the Court is presented in this case with an outrageous completed fraud in which the sale and transfer of securities and interests therein was the central occurrence and the vehicle by which the fraud was perpetrated. It is therefore unlike *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723 (1975) or *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (C.A. 2 1952) where the "buyer" expended nothing. It is unlike *McClure v. First National of Lubbock Texas*, 352 F. Supp. 454 (N.D. Texas), *aff'd.*, 497 F.2d 490 (C.A. 5 1974), *cert. denied*, 420 U.S. 930 (1975) or *Herpich v. Wallace*, 430 F.2d 792 (C.A. 5 1970) where the allegedly fraudulent pledge had not matured into a demonstrable calculated loss. In the case here under consideration, there is a demonstrated loss of a sum in excess of $156,000 the amount paid at closing by the respondents for utterly worthless securities.

The only question is whether respondents' connection with the transaction was sufficiently direct and proximate to conclude that they have "standing" to invoke the federal anti-fraud securities laws. It can hardly be denied that a fraud has occurred and that respondents were the principal victims. Since the question of "standing to sue" relates only to the posture of the respondents, and not to the ultimate liability of Bankers nor the theory under which Bankers may be held,[6] a denial to them of

6. The Second Circuit held not only that respondents were purchasers but that Bankers was a seller by virtue of its release of the pledged shares on receipt of funds of a third party in satisfaction of the pledge. Respondents believe that the reasoning of the Second Circuit is sound in reaching this conclusion; however, even if Bankers were not a "seller" it certainly aided and abetted the seller and may be held liable on that ground.

"standing to sue" would call into question their right to maintain an action for federal securities fraud, on this state of facts, against Kates, an unthinkable result. In this connection, the Court's attention is respectfully invited to the language of *Herpich v. Wallace, supra* at 805:

> "The law of standing has been concerned almost entirely with public law questions such as determinations of constitutionality and review of administrative or other governmental action. Every plaintiff in the federal courts, however, must satisfy the Court that he is a proper party to maintain the action he brings — that he has a personal stake in the outcome of the controversy. *See Flast v. Cohen*, 392 U.S. 83, 101, 88 S. Ct. 1942, 1953, 20 L.Ed.2d 947 (1968); *Baker v. Carr*, 369 U.S. 186, 204, 82 S.Ct. 691, 703, 7 L.Ed.2d 63 (1962). 'The various rules of standing applied by federal courts have not been developed in the abstract. Rather they have been fashioned with specific reference to the status asserted by the party whose standing is challenged and to the type of question he wishes to have adjudicated.' *Flast v. Cohen*, 392 U.S. 83, 101, 88 S.Ct. 1942, 1953, 20 L.Ed.2d 947 (1968). In the context of a plaintiff seeking to invoke a remedy afforded by §10(b) of the Exchange Act and Rule 10b-5 '[t]he first question is whether the plaintiff alleges that the challenged [conduct] has caused him injury in fact, economic or otherwise.' *Association of Data Processing Service Org. Inc. v. Camp*, 397 U.S. 150, 152, 90 S.Ct. 827, 829, 25 L.Ed.2d 184 (1970). The second question is whether 'the interest sought to be protected by the complainant is arguably within the zone of interest to be protected' by §10(b) and Rule 10b-5 thereunder."

I.

Respondents clearly have standing to sue.

(a)

It is true that respondents described themselves as lenders, in their affidavits to the District Court rather than investors, but the documents in the record show them to be "buyers" in the classic sense and both Arnold, the alleged borrower, and Bankers itself, regarded respondents as buyers.

(a) Whatever respondents' and Arnold's (and Fowler's) original intention, their understanding is memorialized in the only document exchanged between them, a letter from Arnold to Mallis, countersigned by Fowler and dated March 3, 1972, the date of the closing, describing Mallis' interest as a "participation in the purchase of 40,384 shares of Equity National Industries Inc." with a limitation of a "profit of $50,000.00 for your participation in this trade." This participation is further described in the letter as an investment (A49).

Repayment to Mallis of his advance of $156,000 is not promised or guaranteed by Arnold or Fowler and neither ever executed a note or other evidence of debt in favor of the respondents or either of them.[7]

(b) Any claim of respondents of debt owing from Fowler

7. Appellant argues (Appellants' Brief, p. 21, n.12) that respondents were to earn "interest" on the "loan" at 383% per annum. The exaction of interest of this character is felonious under the New York law, New York Penal Law §190.40, McKinney's Consolidated Laws of New York, Volume 39. Since the law never assumes a criminal intent, the increment agreed to, $50,000 for 30 days must have been intended as nothing more than a participation in anticipated profit, limited, however, to $50,000. Under the New York cases there is a strong presumption militating against a finding of usury. See, *e.g. Cusick v. Ifshin*, 70 Misc. 2d 564 (1972).

and Arnold to Mallis in the state court action commenced by Mallis against Arnold and Fowler is denied.

(c) The contract of purchase between Kates and Arnold described Arnold, the buyer of record, "as attorney" (A23, A25), a representative term. Arnold describes Mallis' participation as "probably" an investment not a loan in Arnold's sworn testimony taken in the Supreme Court action (A142-A144).

(d) Finally, in his affidavit of January 12, 1973, submitted in support of the motion to dismiss the state court action, Nathan Silverman, the attorney for Bankers who attended the closing and who was associated with Bankers attorney of record, states:

> "On March 3, 1972, the following persons came to our office to close the matter: the defendant Kates, Jack B. Fowler, Jr. a stockbroker (sued herein), Jack J. Arnold (sued herein), the attorney representing the *purchaser*, plaintiff herein, and John A. Murfitt, an assistant vice president of Franklin National Bank where the purchaser had an account and who was to provide the funds for such purchase. The said representative of Franklin National Bank brought with him official checks to pay for the purchase of the said stock. I might mention that as stated above, that our office was offered as a facility to accomodate the parties involved. I did not know and I was never told the name of the purchaser nor was I interested. Also I did not know whether the stockbroker Fowler represented Kates or whether he represented the purchaser and again I was not interested"(A159). (Italics in original).

Thus, according to Silverman he knew that Arnold was not the purchaser; he knew that Fowler was not the purchaser; and he knew that Murfitt of Franklin National Bank was not the purchaser; he knew that the purchaser was someone who had an account at the Franklin National Bank and that that individual was not present at the closing; he did not know the name of the purchaser nor was he interested. The description fits the respondents.[8]

(b)

Assuming, notwithstanding the foregoing, that respondents were in the literal sense not "buyers" but were rather pledgees, they should still not be foreclosed from the protection afforded by the Federal Anti-Fraud Securities Laws.

Herpich v. Wallace, supra, held that a "mere pledge" could not support an action under §10(b) of the Exchange Act and Rule 10b-5 without an allegation of foreclosure and sale. *McClure, supra,* held essentially the same; that is, that the pledge of stock must have culminated in a sale of some kind for these statutes to be applicable. No well-considered case has denied the applicability of this legislation to a plege transaction which, after default, has culminated in a sale through

8. Bankers' dismissal of the state court action was founded on its representation to that Court that it believed at the time of closing that the stock was valuable and that there was no proof it knew or had reason to believe otherwise (A61, A159). The existence of the exchange of correspondence between Bankers and Equity a year prior to closing was not then known to respondents and was withheld by Bankers which made contrary representations as above set forth. Having obtained a dismissal of the state court action on that spurious ground while there conceding that respondents were "purchasers" Bankers now seeks to avoid liability under the federal anti-fraud statutes on the theory that respondents were not "purchasers" while not seriously arguing that appellant did not know the stock was worthless at the time of closing. If for no reason other than to avoid a manifest miscarriage of justice, Bankers should now be estopped from denying that respondents were "purchasers."

foreclosure. Assuming that the views expressed in these opinions ought to be preferred over the more expansive view of the Second Circuit that a pledge of stock is a transaction which is, *per se,* a transaction which is within the coverage of this legislation, the rationale of these cases could be satisfied by a pledgee going through the empty formality of foreclosure and sale of worthless or tainted securities.

In *Lincoln National Bank v. Lampe,* 414 F. Supp. 1270 (N.D. Ill. 1976), plaintiff alleged that the defendant had pledged counterfeit securities to secure plaintiff's loan to defendant. Plaintiff did not foreclose on the securities and sell them prior to bringing suit alleging 10(b) and 10b-5 violations. The *Lampe* court, which ruled with the benefit of the teaching of *Blue Chip, supra,* held that actual foreclosure would be a futile gesture and granted plaintiff standing to sue. *Lampe, supra,* is consistent in concept with *Vine v. Beneficial Finance Company,* 374 F.2d 627 (C.A. 2), *cert. denied,* 389 U.S. 970 (1967), in that in the former, plaintiff was deemed a "constructive seller," and in the latter plaintiff was deemed a "constructive foreclosure." In both cases the Court held that "technical sales" were not necessary to comply with the standing requirement.[9] The case presently before the Court is also like *Commerce Reporting Co. v. Puretec Inc.,* 290 F. Supp. 715 (S.D.N.Y. 1968); *Goodman v. H. Hentz & Co.,* 265 F. Supp. 440 (N.D. Ill. 1967) and the de facto seller exception evolved in such cases as *James v. Gerber Products,* 483 F.2d 944. Were it not for the fact that respondents have been presumably enjoined by the Delaware Chancery Court from foreclosing on the pledge and selling the stock there would not even be occasion to discuss their "standing" for they would have gone through the formalistic step and "futile gesture" of foreclosing and selling.

9. The result reached in this case by the Court below as well as the approach and the result in *Lincoln National Bank v. Lampe, supra,* are exhaustively examined and approved in 52 N.Y.U. L. Rev. 3 (scheduled for distribution in October, 1977).

There is a close correlation between the language of Rule 10b-5, promulgated under the authority of §10b of the Securities and Exchange Act of 1934, 15 U.S.C. §78J(b) and §17A of the Securities Act of 1933, 15 U.S.C. §77(a). The language of both is virtually identical. However, the question of whether a private right of action may be maintained under §17A of the Securities Act of 1933 appears to be an open one, at least in the Second Circuit. *Globus v. Law Research Service Inc.*, 418 F.2d 1276 (C.A. 2d 1969) was a case where the Second Circuit had occasion to compare the two and indeed to compare the 1933 Act with the 1934 Act. The Second Circuit said in *Globus, supra*, at 418 F.2d 1286:

> ". . . courts have endeavored to treat the '33 and '34 Acts in pari materia and construe them as a single comprehensive scheme of regulation. *U.S. v. Morgan*, 118 F. Supp. 621, 691 (S.D.N.Y. 1953); *Brown v. Gilligan Will & Co.*, 287 F. Supp. 766, 775 (S.D.N.Y. 1968); *Rosenberg v. Globe Aircraft Corp.*, 8 F. Supp. 123 (E.D. Pa. 1948); *Lennerth v. Mendenhall*, 234 F. Supp. 59, 62 (N.D. Ohio 1964). Professor Loss has written that the two statutes 'are as closely related as two nominally separate statutes could be.'"

Nevertheless, the Second Circuit found it unnecessary to imply a civil remedy under §17A of the 1933 Act in the *Globus* case simply because it would be duplicative of the relief otherwise granted under §10b of the 1934 Act and Rule 10b-5. In *Architectural League v. Bartos*, 404 F. Supp. 304 (S.D.N.Y. 1975), the Court held that a civil action may not be implied under §17A of the 1933 Act. Therefore, should this Court conclude that respondents do not have "standing" to sue under §10b and Rule 10b-5 because of the definitional term of "seller", etc. as contained in the 1934 Act, respondents respectfully request that this Court indicate whether these respondents, the victims of such outrageous fraud, may maintain an action under

§17A of the 1933 Act under which Bankers was most assuredly a seller and respondents most assuredly buyers under any view of the facts.[10]

In behalf of the respondents, it is respectfully urged that the Second Circuit was correct in reading the 1933 and 1934 Acts in *pari materia* in this case. The legislative history of the Acts indicates that the 1934 Act was intended to broaden the coverage of the 1933 Act rather than to limit its scope.

The definitional distinctions between the 1933 and 1934 Acts of the terms "sale," "sell," "buy" and "purchase" do not necessarily mandate a conclusion either that respondents were not "buyers" or that Bankers was not a "seller" within the meaning of the 1934 Act. The 1934 Act "includes" certain specified transactions within the foregoing terms but does not necessarily exclude others "arguably within the zone of the interests to be protected," *Herpich v. Wallace, supra* at p. 805, quoting with approval from the decision by this Court in *Association of Data Processing Service Org. Inc. v. Campe, supra*. Additionally, appellants gloss over the "or otherwise acquire" and the "or otherwise dispose of" in the definitional language of §3(a)(13) and §3(a)(14) of the Securities and Exchange Act of 1934.

II.

Bankers Trust was a "seller" of securities which were acquired by respondents.

Securities Act of 1933, §2(3), 15 U.S.C. 77b(3) defines a sale as "every contract of sale or disposition of a security or interest in a security, for value." Within this definition Bankers was a seller on March 3, 1972 when it relinquished its security interest in these worthless stocks for a value provided by respondents, at

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10. This question was expressly left open by this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, at page 733, footnote 6.

least for the purposes of the Securities Act of 1933. It "otherwise disposed of" stock for the purposes of the 1934 Act, and therefore "sold" them. Similarly, Kates "sold" stocks to Bankers within the meaning of the Securities Act of 1933 when he pledged the stock in the first instance; he received value and gave an "interest" in a security, *i.e.*, a security interest. Moreover, it cannot be disputed that Kates "sold" the stock on March 3, 1972 within the meaning of both Acts and Bankers aided and abetted in the consummation of the sale; indeed, the sale could not have been completed absent Bankers' participation.

III.

The sale, purchase and pledge were interdependent.

In any view, the argument of Bankers, repeatedly advanced in their brief to this Court, that the transaction between Kates and Bankers was separate and apart from the transaction between Kates and respondents or those representing them is simplistic and rhetorical. The transactions were simultaneous and interdependent. Neither could have been completed without the simultaneous completion of the other. In the final analysis respondents' money was knowingly accepted by Bankers in satisfaction of Kates' loan and Bankers knowingly allowed respondents to succeed to Bankers' own position as victims of a stock swindle, all in a single sitting. No attempt to fragmentize this single transaction into its component parts can change this simple fact.

IV.

The earlier dismissal of the Supreme Court action is not *res judicata*.

Respondents instituted an action in the New York Supreme Court naming as defendants Bankers Trust Company, Arnold, Fowler, and Kates. The action is still pending as against the

other defendants but has been dismissed on a pleading motion against Bankers. This Court will observe that Bankers moved for an order of dismissal pursuant to New York Civil Practice Law and Rules §3211(a)(7) upon the grounds that the complaint failed to state a cause of action (A91). The motion was granted on that ground and an order of dismissal was signed (A92). It will be observed that the order of dismissal is not upon the merits and in fact the order of dismissal was based upon a defective pleading rather than a defective case.

Rule 5013 of the New York Civil Practice Law and Rules provides:

> "A judgment dismissing a cause of action before the close of the proponents' evidence is not a dismissal on the merits unless it specifies otherwise, but a judgment dismissing a cause of action after the close of the proponents' evidence is a dismissal on the merits unless it specifies otherwise."

It will be observed that the state court order of dismissal does not specify that the same is "on the merits" nor did the dismissal come after the close of plaintiffs' evidence since no evidence was ever presented.

Moreover, the ruling case law of the State of New York is that the doctrine of *res judicata* or collateral estoppel does not apply to a dismissal in a fraud case where the dismissal itself was obtained through fraud. *See, e.g., Burbrooke Manufacturing Co. Inc. v. St. George Textile Corp.*, 283 App. Div. 640 (1st Dept., 1954).

In the affidavit of Jack Jasper, submitted in support of the application of Bankers for a dismissal in the state court action, he, as assistant treasurer of Bankers, told the Court that:

> "For plaintiff to allege that Bankers knew that the legended Equity stock was 'worthless' is a gratuitous statement not borne out by the facts." (A57).

In the affidavit of Nathan Silverman, an attorney associated with Charles Leeds, attorney for Bankers, in support of the application for an order of dismissal by the state court, he stated:

> "Although not germane to the issue of liability on the part of Bankers there is no proof that Bankers knew that the Equity stock was 'worthless.' On the contrary, as will be seen by the annexed affidavit of Jack Jasper, the Equity stock was considered valuable when accepted as collateral and continued to be so considered up to the time of closing on March 3, 1972." (A61).

The truth of both of these statements is called into serious question by the exchange of correspondence between Equity and Bankers during a period commencing March 1, 1971 and April 20, 1971 (A95-A97). The existence of this correspondence was not disclosed when Bankers made its motion to dismiss the state court action and respondents were unaware of its existence since the order of dismissal, being based upon a motion addressed to the pleadings, preceded any discovery.

CONCLUSION

Bankers, having been victimized by a stock swindle, willingly participated in a transaction by which it effectively substituted respondents as the victims in place of itself. It was able to accomplish this by attending a closing at which time its loan was repaid not by Kates, the borrower, but by a third party advancing an original consideration not only to Kates but to Bankers as well in consideration for which Bankers declared the pledge at an end and delivered this worthless stock to the party furnishing the consideration. In behalf of respondents it is respectfully submitted that a miscarriage of justice would occur if the respondents here were denied standing to invoke the federal anti-fraud securities laws. There should be an affirmance.

Respectfully submitted,

s/ Noel W. Hauser
Attorney for Respondents

FOR ARGUMENT

Supreme Court, U. S.
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No. 76-1359

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

BANKERS TRUST COMPANY,

Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

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November 25, 1977

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REPLY BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

In our main brief, we have shown that the Second Circuit erred in reversing Judge Pollack and holding that Respondents had standing to maintain an action against Bankers Trust under Section 10(b) and Rule 10b-5, because a pledge of securities as collateral for an indebtedness is not a "purchase" or "sale" within the meaning of the Act. We have likewise shown that Bankers Trust's release of a pledge of collateral to its borrower Kates related to repayment of the indebtedness and was not "in connection with" the loan transactions between the plaintiffs and third-parties.

The brief of the Respondents Mallis and Kupferman (hereinafter referred to singly as "Mallis") and the Amicus Brief of the Securities and Exchange Commission (hereinafter "SEC") employ factual distortions and legal fallacies to confuse and circumvent the legal issues set forth in Bankers Trust's main brief. Accordingly this brief reply is necessary.

1. The pending State Court actions against Bankers Trust

Both Mallis and the SEC urge that an action under Section 10(b) and Rule 10b-5 is necessary because the State Court action was dismissed (Mallis brief, pages 10, 14-16, SEC brief, page 3). Both fail to point out that in this case, as in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, that the State Court actions, to which Bankers Trust is a party, are still pending involving ordinary questions of fact. (*Blue Chip Stamps*, 421 U.S. at 738, fn. 9). Although the action was originally dismissed against Bankers Trust, two defendants therein, Jack J. Arnold ("Arnold") and John B. Fowler, Jr. ("Fowler"), instituted third-party actions which are still pending in the State Court. (See our main brief, fn. 9, pages 11-12, fn. 23, page 37). In attempting to allow Mallis and Kupferman, as pledgees of the securities from Arnold and Fowler, to expand the concept as to who may sue under Section 10(b) and Rule 10b-5, Mallis and the SEC seek to "permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence . . ." *Blue Chip Stamps*, 421 U.S. at 741.

Over the vigorous opposition of Mallis and his attorney, the State Court directed Mallis to appear for an examination before trial in that action and produce for examination by Bankers Trust the signed depositions of Fowler and of Arnold. A copy of the order of the State Court entered on May 27, 1977 (four days after certiorari was granted in this case) is reproduced in the appendix to this reply brief *infra* App. 12-16.[1] Similarly, Bankers Trust was granted the right in the State Court action to examine Fowler, again after vigorous opposition of Fowler's attorney. That order was granted on July 7, 1977. That examination was held on notice to the attorneys for all parties, including Mallis. The testimony demonstrated beyond question that the allegations with respect to Bankers Trust, whether in the State or Federal action, are totally without merit. Although the facts brought forth in the Fowler deposition are not important to the ultimate disposition of the question here involved, those facts are significant in showing that this action is simply one, where, as in *Blue Chip* the "in terrorem" threat of a securities fraud action is being utilized in an attempt to bludgeon a settlement from Bankers Trust.

2. The factual misstatements in the Mallis and SEC briefs

Both Mallis and the SEC in their briefs make assertions that are not supported by the record and which are in fact contradicted by both the Record and Fowler's testimony, both in 1973 and his more recent examination of October 13, 1977.

1. Although stating that the record is unclear with respect to the act of Bankers Trust's representative, the

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[1] ("A.") refers to the appendix heretofore filed with the Court. ("App.") refers to the appendix at the end of this brief. Fowler EBT refers to the examination of John B. Fowler, Jr. on October 10, 1977.

SEC flippantly characterizes it as the "misrepresentation". (SEC brief, page 5). This is contrary to the position that Mallis and Kupferman have long taken in the State Court proceeding (A. 68, 70 and 75). It is likewise contrary to the testimony of John Fowler. Fowler testified that the alleged false affidavit was dictated by Arnold, relying on the answers to questions given by Kates. Any suggestions made by the Bankers Trust representative were "more the editorial than the substantive." (Fowler EBT, pages 114 to 118). Thus, contrary to the statement in Mallis's brief, the Kateses affidavit was prepared by Mallis's own attorney, Arnold.

2. In an attempt to create innuendos of fraud, the SEC asserts that the closing was attended by "Arnold and Fowler, the Kateses and a representative of Mallis and Kupferman." (SEC brief, at page 4). Mallis and Kupferman's own version of the facts differ from that of the SEC. Mallis states that "Arnold, the attorney, and Murfitt, a vice president of the Franklin National Bank", were the representatives. (Mallis brief at page 4). Certainly the Commission should at least accept Mallis and Kupferman's own version of who their representative was instead of attempting to pervert the facts to satisfy a legal result.

3. The SEC asserts that Mallis and Kupferman "would not have made the loan had they known that the collateral designed to secure it was worthless paper." (SEC brief, pages 15-16). This assertion flies in the face of the agreement between Arnold and Fowler and Mallis whereby they expressly did not expect to be repaid from the Equity National stock, which had been pledged, but were going to be "reimbursed" from the transfer during March, 1972 of "a block of 100,000 shares of Merck & Co." (A. 49, 75). Indeed Fowler's testimony very clearly shows that the parties relied on the Merck stock and not the Equity National stock. Fowler stated that Equity National "wasn't the sort of stock you should put good money into," but "this fascination stemmed from the pot of gold at the end of the rainbow, which was the Merck stock." (Fowler EBT at 27).

4. The assertion by Mallis that Bankers Trust failed to disclose that Equity National instituted a lawsuit against Bankers Trust is likewise baseless. (Mallis brief, fn. 4, page 4) Fowler in his testimony, which Mallis sought to avoid producing in the State Court action, admitted that he did not rely on Bankers Trust but he had contacted the National Bank of Georgia, the transfer agent, with respect to the existence of any restrictions on the stock. He was informed by the National Bank of Georgia—on two separate occasions—that the only restriction on the stock was the legend. Similarly, Fowler testified that on February 28, 1972, he had contacted Childs, the president of Equity National, who informed Fowler that "they were suing Kates, that the agreement had been dissolved and the stock would not be transferred." (Fowler EBT 86). Arnold, Mallis's representative, was made fully aware of these facts by Fowler (Fowler EBT 86-88). The only question asked of Bankers Trust was whether it would deliver the securities (A. 114). Since Bankers Trust had not been sued and since Silverman did not know of any lawsuit, he merely stated that Bankers Trust would return the collateral to Kates for redemption. If Mallis and the SEC have any complaints about the lack of disclosure, that lack of disclosure was not by Bankers Trust—which had no contact with Mallis and Kupferman—but by Arnold and Fowler.

3. A pledge is not a sale under the Uniform Commercial Code and State Law

The SEC states (at its brief p. 21) that "a pledge is . . . a 'sale' under . . . the Uniform Commercial Code (and) other state law."

To the contrary, the Uniform Commercial Code does not include pledge relationships within its definition of "sale", which "consists in the passing of title from the seller to the buyer for a price." UCC Sections 9-105(3), 2-106(1). "Purchase" under the Code is defined broadly, because the term is used for a different purpose, and includes "taking by sale . . . , mortgage, pledge . . . gift or any other voluntary transaction creating an interest in property." UCC Section 1-201(32). However the term "purchase" is never used in Article 9 of the Uniform Commercial Code, which is the only Article dealing with the creation, validity and extinction of pledges. In fact, the Code expressly exempts pledgees from "contract or tort liability upon the secured party for the debtors acts or omissions", precisely the claim plaintiffs press herein. UCC Section 9-317.

The "other state law" referred to by the SEC turns out to be a 1932 case of doubtful validity from a lower federal court. In all events, that court was interpreting the California "Blue Sky" statute, which had a different definition of "sale" than that found either in the 1934 Act or at common law. See SEC brief at 22; *Cecil B. DeMille Productions* v. *Woolery*, 61 F.2d 95 (C.A. 9, 1932).

4. Under the 1934 Securities Exchange Act, a pledge of securities is not a purchase or sale

In its zeal to impose the antifraud provisions of the securities laws upon all commercial loan transactions in which securities are pledged as collateral, the SEC essentially ignores the decisive question—whether a pledge of securities involves a "purchase" or a "sale".

The SEC argues that "because of the generality" of the definitions of "purchase" and "sale" in the 1934 Act, the focus "is not on the definition, but on the broader issue whether Bankers Trust's "alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule.'"[1] (SEC brief at page 14). The SEC then concludes that the antifraud provisions should apply because this case "charges only a garden variety type of fraud, based upon a misrepresentation of the type courts traditionally have resolved." (SEC brief at 28-29, 16).

But Section 10(b) and Rule 10b-5 require that the fraud be in connection with the "purchase or sale" of securities, not merely be in connection with any transactions involving securities. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). If there is no "purchase or sale" of securities, then there is no cause of action under Section 10(b) and Rule 10b-5 for alleged securities fraud. *See id.* at 760 (Powell, Jr., concurring): "It may well be conceded that *Birnbaum* does allow some fraud to go unremedied under the federal securities Acts." *See also id.* at 738.

The definitions of "purchase" and "sale" in the 1934 Act are not, contrary to the assertion by the SEC, too "general". The terms are carefully defined in the 1934 Act to be themselves. See *Blue Chip Stamps*, *supra*, at 733 n.5: The 1934 Act is a "carefully drawn statute [that] itself defines the term 'sale.'" The fact that the terms are defined

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[1] The SEC purports to quote *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180 and *Tcherepnin* v. *Knight*, 389 U.S. 332, in support of its position that pledges are encompassed within the 1934 Act definition. Neither case however has anything whatsoever to do with whether a pledge is a "purchase" or "sale". *Tcherepnin* does not involve any issues even arguably analogous to those here. In *Capital Gains*, the court held only that an exchange of shares as a result of a merger was a "purchase or sale" because it involved a transfer of ownership "like a typical cash sale or share exchange." *Id.* at 466.

to "include" contracts to purchase and sell only adds executory as well as executed purchases and sales—as this Court has stated, there is no cause of action under Section 10(b) "when there is no actual purchase or sale of securities, or a contract to purchase or sell, affected or tainted by a violation of § 10(b)." *Id.* at 735.

In arguing the generality of the 1934 Act definitions, the SEC finds comfort in the residual clauses "otherwise acquire" and "otherwise dispose of." But the SEC's characterization of a pledge of securities as a "disposition" of them imputes to the clause its broadest possible sense, so that it includes any transfer of physical possession. Such an interpretation flies in the face of the "commonly accepted meanings" of the "ordinary words" "purchase" and "sale", which require transfer of ownership. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 at 199; *Blue Chip Stamps, supra*, 756 (Powell, Jr., concurring): *SEC* v. *Sterling Precision Corp.*, 393 F.2d 214, 217-18 (2d Cir. 1968) (Friendly, J.).

The SEC cites numerous transactions which federal courts have held were encompassed within the terms "purchase" and "sale"—"mergers, issuance of stock, forced sales, and exchanges of shares" (SEC brief at 20-21; footnotes omitted). All those transactions, however, involve precisely the element missing in a pledge transaction—transfer of ownership. As discussed in our main brief at pages 17-18 and the Clearing House brief at pages 5-7, a pledgee does not own, or even have a contingent right to own, the pledged property. Even upon default, the pledgee's right to sell the collateral is only as agent for, and for the account, of the pledgor.[8]

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[8] A "purchaser" of securities acquires at least four important indicia of ownership: 1) the right to enjoy an increase in the value of the securities; 2) the right to receive dividends; 3) the right to vote the securities; 4) the right to dispose of the securities when, and to whom, the owner wishes. A pledgee of securities acquires not one of these rights.

The SEC also seeks to equate the definition of "sale" in the 1934 Act with the definition in the 1933 Act, which includes transfers of an "interest in a security," and then argues that a pledge of a security involves transfer of an "interest" in it. However, leaving aside the questionable interpretation of the 1933 Act definition, the SEC's argument leads to the opposite conclusion. According to this Court, because the 1934 Act is a "carefully drawn statute [that] itself defines the terms 'sale'" that should be contrasted "with Congress' separate definition and use" of the term in the 1933 Act. *Blue Chip Stamps*, at 733 fn. 5.

As a policy justification for Section 10(b)'s coverage of pledges, the SEC implies that the parties to a pledge transaction otherwise would be functionally remediless. But the parties to a pledge transaction, unlike a purchase or sale, rarely need resort to an action for fraud. By the nature of the transaction, the pledgor has an absolute contractual right to return of the collateral upon repayment. And the pledgee ordinarily need not resort to a fraud action because he always has an action on the note. In all events, in the rare case in which a fraud action might serve some purpose, state law causes of action are readily available.

The SEC tips its hand when it asserts parenthetically that "investors" is a "category which includes lenders" (SEC brief at 16). Never has this Court ever held or otherwise intimated that lending, like "investing", is regulated as a matter of course by the securities laws. A holding to that effect would vastly expand the scope of the securities laws and would do so without any support in the legislative history of the securities acts.

A pledge transaction does not involve a "purchase" or "sale" between the pledgor and pledgee, and for that rea-

son is not within the scope of Section 10(b) of the 1934 Act.[4]

Conclusion

For these reasons and the reasons set forth in our main brief, the judgment of the Court of Appeals should be reversed, and the judgment of the District Court dismissing the complaint against Bankers Trust Company should be reinstated.

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New York, New York 10019

November 25, 1977

[4] In an attempt to muddy the important legal question herein involved, the SEC makes erroneous bold statements. (a) Thus the SEC asserts that Bankers Trust statement that "banks were specifically exempted from any provision of the securities laws (Br. 30) is erroneous." The SEC does not point out that this is a direct quotation from this Court in *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148 at 157. (b) The SEC relies upon lower court cases such as *SEC* v. *National Bankers Life Insurance Company*, 477 F.2d 920 (CA 5, 1973) and *American Bank and Trust Co.* v. *Joste*, 323 F.Supp. 943 (WD Louisiana, 1970) (SEC Brief, page 30). These cases were relied upon by Mrs. McClure, and expressly rejected, by the Fifth Circuit in holding that a pledge was not a sale for purposes of a civil damage action under Section 10(b) and Rule 10b-5. See *McClure* v. *First National Bank of Lubbock Texas*, 497 F.2d 490, 495 (C.A. 5, 1974) *cert. denied* 420 U.S. 930 (1975).

SUPPLEMENTAL APPENDIX

Order of State Court in Pending Action.

Present: HON. ARNOLD L. FEIN, Justice.

SAMUEL MALLIS

against

JEROME B. KATES, et al.

The following papers numbered 1 to read on this motion, submitted.

	Papers Numbered
No. 52 on Calendar of Mar. 21—1977.	
Notice of Motion—Exhibits and Affidavits Annexed	1–4
Answering Affidavit	5
Replying Affidavits	6–8
Exhibit	9

Upon the foregoing papers this motion is decided in accordance with accompanying memorandum decision.

ALF
J. S. C.

Dated May 26 1977

SUPREME COURT : STATE OF NEW YORK

COUNTY OF NEW YORK : SPECIAL TERM PART I

INDEX No. 25831/72
No. 52 of Mar. 21/77

SAMUEL MALLIS,

Plaintiff,

against

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR.,

Defendants.

JOHN B. FOWLER, JR. and JACK J. ARNOLD,

Defendant and Third-Party Plaintiff,

against

BANKERS TRUST COMPANY,

Third-Party Defendant.

FEIN, J.:

Motion by plaintiff for a protective order vacating the demand for production of documents and the notice of deposition heretofore served by third party defendant Bankers Trust Company is granted only to the extent that items 3 through 6 of Banker's notice of discovery, and the corresponding items in the notice of examination are vacated as lacking necessary specificity, and is otherwise denied.

Contrary to plaintiff's apparent suggestion, a third party to the action is not in an inferior position in the conduct of disclosure and pretrial proceedings. Under applicable rules, such a party is a party for all purposes. Nor is the filing of a note of issue and statement of readiness dispositive of the issue raised under the circumstances. It appears that the action was marked off the calendar by Justice Levy after the case had been assigned to I. C. Part 4. The case, therefore, is not on the calendar at this time and, under applicable rules, discovery may be conducted. Equally lacking in merit is the suggestion that the transcripts of examinations before trial and the exhibits used and marked for identification thereat constitute the work product of counsel.

Nevertheless, items 3 through 6 of the discovery notice do not identify the documents to be produced with sufficient particularity as required by appropriate court rules. Nor is there any reason shown to vary from the normal procedure by first conducting examinations before trial to ascertain the existence of identifiable documents before an appropriate notice to produce is served pursuant to CPLR 3120.

Plaintiff shall appear and submit to examination before trial to be held at Special Term Part 2 on July 5, 1977 at 10 A.M., said examination to continue from day to day until completed. Within ten days prior to that date, plaintiff shall produce the documents responsive to items 1 and 2 of Bankers' notice to produce. This disposition is without prejudice to the service of an appropriate notice of discovery after the existence of identifiable documents has been made known upon the deposition to be conducted as herein directed.

Serve a copy of this order with notice of entry without undue delay.

Dated: May 26, 1977

ALF
J S C

Demand for Production of Documents.

SUPREME COURT OF THE STATE OF NEW YORK

COUNTY OF NEW YORK
Index No. 25831/72

SAMUEL MALLIS,

Plaintiff,

—against—

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR.,

Defendants.

JOHN B. FOWLER., and JACK J. ARNOLD,

Defendant and Third-Party Plaintiff,

—against—

BANKERS TRUST COMPANY,

Third-Party Defendant.

PLEASE TAKE NOTICE that third-party defendant Bankers Trust Company hereby requires plaintiff, Samuel Mallis to produce for inspection and copying, pursuant to Rule 3120 of the Civil Law and Rules at the offices of Charles Leeds, Esq., 1775 Broadway, 12th Floor, New York, New York 10019 (212) MU 2-5888 on Wednesday, March 16, 1977 at 10:00 A.M. the following documents:

1. The signed examination before trial of John B. Fowler, Jr. dated September 12, 1973 and continued on

September 18, 1973 and the documents annexed thereto, including the following:

(a) 1972-1973 diary of John B. Fowler, Jr.

(b) All records and reports of J.S. Love & Co.

(c) Rescision agreement

(d) Diary of telephone calls from Love & Co.

(e) Letter agreement of April 25, 1972.

(f) All checks issued by John B. Fowler, Jr. to Samuel Mallis, Jerome B. Kates and Dr. Franklyn Kupferman.

(g) All correspondence sent from John B. Fowler, Jr. to Samuel Mallis.

2. The signed examination before trial of Jack J. Arnold taken by the attorneys for Samuel Mallis and or documents referred to therein.

3. All correspondence between Samuel Mallis and Jack J. Arnold, Jr. from the period of 1970 to and including March 2, 1977 whether written by Samuel Mallis or his attorneys on his behalf to Jack J. Arnold, Jr.

4. All correspondence between Samuel Mallis and Jerome B. Kates or Judith Kates during the period from February 1, 1972 to and including March 2, 1977, whether the correspondence was written directly by Samuel Mallis or his attorneys on his behalf to Jerome B. Kates and Judith Kates.

5. All papers filed and affidavits submitted on behalf of Samuel Mallis in any 10b5 action instituted in his behalf whether that action was in the Southern District of New York or the Eastern District of New York.

6. All settlement agreements between Samuel Mallis and Jerome B. Kates and Judith Kates, Jack J. Arnold and John B. Fowler and William London.

Dated: New York, New York
March 3, 1977

Yours, etc.,

Charles Leeds, Esq.
Attorney for Third-Party Defendant
Bankers Trust Company
1775 Broadway
New York, New York 10019
(212) MU 2-5888

To: Max Kaplan, Esq.
Attorney for Jack J. Arnold
120 East 56th Street
New York, New York 10022

Abraham Epstein, Esq.
Attorney for Samuel Mallis
450 Seventh Avenue
New York, New York 10001

Olwine, Connelly, Chase, O'Donnell and Weyher, Esqs.
Attorneys for John B. Fowler, Jr.
299 Park Avenue
New York, New York 10017

Bandler & Kass, Esqs.
Attorneys for Jerome and Judith Kates
605 Third Avenue
New York, New York 10017

MOTION FILED
AUG 18 1977

No. 76-1359

IN THE

Supreme Court of the United States

October Term, 1976

BANKERS TRUST COMPANY,
Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION AND BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, *AMICUS CURIAE*

JOHN L. WARDEN
Counsel for The New York Clearing House Association, Amicus Curiae
48 Wall Street,
New York, New York 10005.

H. RODGIN COHEN
PHILIP K. HOWARD

SULLIVAN & CROMWELL
Of Counsel.

August 18, 1977

IN THE

Supreme Court of the United States

October Term, 1976

No. 76-1359

BANKERS TRUST COMPANY,
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SAMUEL MALLIS AND FRANKLYN KUPFERMAN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF THE NEW YORK CLEARING HOUSE ASSOCIATION FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE*

The New York Clearing House Association hereby moves pursuant to Rule 42 of this Court for leave to file a brief as *amicus curiae* urging reversal of the decision of the court of appeals. This motion is necessitated by the refusal of respondents Mallis and Kupferman to consent to the filing of the Association's brief.

The New York Clearing House Association, founded in 1853, is an association of eleven leading commercial banks in the City of New York.[1] The Association clears commercial drafts and items in the New York area and,

[1] The Bank of New York, The Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Manufacturers Hanover Trust Company, Irving Trust Company, Bankers Trust Company, Marine Midland Bank, United States Trust Company of New York and National Bank of North America.

through its counsel, files briefs before courts of appellate jurisdiction in cases which raise significant questions of law relating to banking.

In the decision below, the court of appeals held that a pledge of stock as security for the repayment of a commercial loan, and the release of such a pledge upon repayment, each constituted a "purchase or sale" of the pledged stock within the meaning of § 10(b) of the Securities Exchange Act of 1934. The decision imposes a general federal antifraud provision upon all commercial loan transactions that are collateralized by securities and thereby supersedes the legal structure governing security interests that has evolved from the common law and statutory draftsmen over hundreds of years.

The New York Clearing House Association, which represents banks with over $6 billion in loans collateralized by securities, believes the decision below was error for the reasons set forth in the accompanying brief. The Association thus respectfully prays that the Court grant this motion for leave to file its brief.

Respectfully submitted,

/s/ *John L. Warden*
JOHN L. WARDEN
Counsel for The New York Clearing House Association, Amicus Curiae
48 Wall Street,
New York, New York 10005.

H. RODGIN COHEN
PHILIP K. HOWARD

SULLIVAN & CROMWELL
Of Counsel.

August 18, 1977

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IN THE

Supreme Court of the United States

October Term, 1976

No. 76-1359

BANKERS TRUST COMPANY,

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v.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, *AMICUS CURIAE*

The New York Clearing House Association, *amicus curiae*, submits this brief on an issue of importance to the commercial banking system: Whether a pledge of stock as security for the repayment of a commercial loan, and the release of such a pledge upon repayment, are each a "purchase or sale" of the pledged stock within the meaning of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

The Court of Appeals for the Second Circuit (per Timbers, J.) held that both a pledge and the release of a pledge constitute such a "purchase or sale" and, con-

sequently, that § 10(b) governs all loan transactions where securities are put up as collateral. This holding is contrary to the language and purpose of the statute, is based upon a fundamental misconception of the nature and consequences of a pledge, and is unsound as a matter of public policy.

Statement of the Case

The facts of this case are detailed fully in the opinions of the courts below. In short, respondents Mallis and Kupferman ("plaintiffs") borrowed $156,000 from Franklin National Bank and reloaned the money to a Mr. Arnold, for a payment of $50,000.[1] Arnold used the proceeds to purchase certain stock certificates purporting to represent an interest in Equity National Industries. The certificates, which Arnold pledged to plaintiffs as security for their loan, apparently proved worthless and Arnold did not repay plaintiffs. Plaintiffs in turn refused to repay their debt to Franklin National Bank. (A129-30; 156-58)

The connection of Bankers Trust Company ("Bankers Trust") to this series of transactions was that the certificates had previously been pledged to it as collateral for a loan to Arnold's seller, a Mr. Kates. Bankers Trust returned the certificates to Kates when, at a simultaneous closing, Kates sold the certificates to Arnold and repaid Bankers Trust with a portion of the proceeds from the sale. (A130-31; 156-58)

[1] Plaintiffs' extension of credit to Arnold for a 30-day period in consideration of a payment of $50,000 appears to have violated the New York criminal usury law. N.Y. PEN. LAW § 190.40 (McKinney Supp. 1976).

Plaintiffs have alleged that Bankers Trust knew when it released the certificates from pledge that they were worthless and apparently contend that Bankers Trust is thereby *ipso facto* liable under § 10(b) to them as subsequent pledgees of the certificates. Plaintiffs also claimed below that they had no obligation to repay their loan from Franklin National Bank because the transaction violated Regulation U, 12 C.F.R. Part 221, promulgated under § 7 of the 1934 Act, 15 U.S.C. § 78g, which regulates the extension of credit for the purpose of "purchasing or carrying" securities.

The district court (Pollack, J.), citing *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), held that plaintiffs were not "purchasers" of securities and that their action therefore did not state a claim against Bankers Trust under § 10(b) of the 1934 Act (A134). Judge Pollack also held that plaintiffs could not invoke Regulation U to avoid their obligation to Franklin National Bank (A131-33).

The court of appeals reversed as to Bankers Trust, holding that plaintiffs' acceptance of Arnold's pledge was a "purchase" of securities under § 10(b) of the 1934 Act, and also that "Bankers Trust was a seller by virtue of its release of the Kateses' pledge", *i.e.*, that the termination of a pledge is a "sale" (A162-65). The court of appeals affirmed plaintiffs' obligation to repay the loan from Franklin National Bank, however, holding that Regulation U was inapplicable because plaintiffs were not "purchasing" any securities as required by § 7(a) of the 1934 Act (A161). The court of appeals did not attempt to reconcile its conflicting definitions of "purchase" under the 1934 Act.

ARGUMENT

I.

Pledge Transactions Are Not Within the Express Scope of § 10(b) of the 1934 Act.

In rejecting recent attempts to expand the coverage of § 10(b), the Court has noted that "[t]he starting point in every case involving construction of a statute is the language itself." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). The language should be read according to "its commonly accepted meaning," *Ernst & Ernst* v. *Hochfelder*, *supra* at 199, and is " 'to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him,' " *id.* at n. 19, quoting *Addison* v. *Holly Hill Fruit Products, Inc.*, 322 U.S. 607, 617-18 (1944).

Section 10(b) of the 1934 Act and Rule 10b-5 thereunder apply by their terms to the "purchase or sale" of securities and only to such transactions. *See Blue Chip Stamps, supra.* "Purchase" and "sale" are "ordinary words," *see SEC* v. *Sterling Precision Corp.*, 393 F.2d 214, 217-18 (2d Cir. 1968) (Friendly, J.), and are thus to be construed according to their "commonly accepted" meanings. *See id.*, (" 'Purchase' is not a peculiarly technical term"); *Blue Chip Stamps, supra* at 756 (Powell, J., concurring) ("sale" has a "long-established legal meaning" applicable under § 10(b)).

A "sale" is a "contract whereby the absolute, or general, ownership of property is transferred from one person to another for a price, or sum of money, or, loosely, for any consideration." WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934). A "purchase" is an "acquisition of title to, or property in, anything for a price; buying for money or its equivalent." *Id.*

The definitional section of the 1934 Act, § 3(a), 15 U.S.C. § 78c(a), does not alter these "commonly accepted" meanings except to make it clear that executory as well as fully executed contracts of purchase and sale are included:

> "(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.
>
> (14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

See Blue Chip Stamps, supra at 750-51. The correlative terms "otherwise acquire" and "otherwise dispose of" are not referred to in the legislative history, but seem to have the effect of including transfers of ownership through barter or in exchange for services, which do not involve, in the strict dictionary sense, a "price" or "money or its equivalent." These terms do not, in any event, derogate from the basic point that "purchase" and "sale" mean the acquisition and disposition of ownership; indeed, they confirm it.

A pledge of securities or other property as collateral for a loan, and the acceptance of such a pledge, do not fall within the "commonly accepted" meanings of "sale" and "purchase" because no title or ownership is passed from pledgor to pledgee. This is true *a fortiori* of the release of a pledge. A pledge does not transfer (or "dispose of") ownership, but creates an entirely different interest, long known to and regulated by the law as a security interest. The release of a pledge does not pass any interest from or to anyone; it simply extinguishes the security interest created by the pledge. These distinctions are matters of both common understanding and legal substance.

A pledge is "a deposit of personal property as security, with an implied power of sale upon default," or a

" 'bailment of goods by a debtor to his creditor to be kept till the debt be discharged.' " L. JONES, COLLATERAL SECURITIES AND PLEDGES § 1 (3d ed. 1912); *accord*, RESTATEMENT OF SECURITY § 1 (1941). Pledgees have "no general property right in the thing pledged, but only a right, upon default, to sell in satisfaction of the pledgor's obligation," and even third parties "cannot regard a pledgee as the actual owner." *Pauly* v. *State Loan & Trust Co.*, 165 U.S. 606, 622 (1897). *See also Burgess* v. *Seligman*, 107 U.S. 20, 29, 37 (1882) ("mere pledgee" contrasted with "true owner"); L. JONES, *supra* § 602.

The physical re-delivery or "release" of the pledged property upon repayment of the secured obligation is not a voluntary act, but a legal duty. The pledgee's security interest in the pledged property is extinguished by operation of law, and the release is not a transfer of ownership, which was never in the pledgee, but a natural consequence of that extinction. L. JONES, *supra* §§ 540, 544; RESTATEMENT OF SECURITY § 37; *see* U.C.C. 9-506.

Even upon default, a pledgee has no right or option to sell the collateral for its own account, but only for the account of the pledgor. *Easton* v. *German-American Bank*, 127 U.S. 532, 537 (1888):

> "In reference to the pledge and to the pledgor, [the pledgee] occupies a fiduciary relation, by virtue of which it becomes his duty to exercise his right of sale for the benefit of the pledgor."

The pledgee must sell the collateral in a "commercially reasonable" manner, U.C.C. § 9-504(3); *see* L. JONES, *supra* § 602; RESTATEMENT OF SECURITY § 49, and must account in such a sale for all proceeds in excess of the debt, U.C.C. § 9-504(2), and for all profits accruing as a result of possession of the collateral. RESTATEMENT OF SECURITY § 27; *Burgess* v. *Seligman*, *supra* at 29. The pledgee may always collect on the note, either instead of realizing on

the collateral or if the proceeds from sale are insufficient. L. JONES, *supra* §§ 590, 597; RESTATEMENT OF SECURITY § 48.

Nor does a pledge of stock carry any other of the important indicia of ownership. Taxes incident to stock ownership are payable by the pledgor, L. JONES, *supra* § 176a, and the pledgor normally has the right to vote the stock, *id.* at § 441; *cf. Burgess* v. *Seligman*, *supra*. Pledgees are immune from liability as stockholders, *Pauly* v. *State Loan & Trust Co.*, *supra*; L. JONES, *supra* §§ 445-456. Pledgees at common law are even prohibited from purchasing the pledged property upon default absent supervision by a court or agreement by the pledgor. L. JONES, *supra* § 635; RESTATEMENT OF SECURITY § 51; *Easton* v. *German-American Bank*, *supra* (a pledgee "is by a familiar maxim of equity forbidden to purchase for his own use at his own sale."). *Cf.* U.C.C. § 9-504(3).

Thus, a pledgee is but a lender-bailee with a contractual right to repayment of the debt to which the pledged security is "collateral," as well as a contingent right, if the pledgor defaults on the loan, to act as a sales agent for the pledgor and to receive a fixed sum out of the proceeds. The SEC's rules under the 1934 Act are in accord with the common law, and recognize that the pledgee is in effect a custodian of the stock for the pledgor and has no ownership interest.[3]

---

[3] Rule 16a-6, 17 C.F.R. § 240.16a-6, which governs stock ownership filings by corporate insiders, expressly notes that a pledge of stock is not a transfer of a security and, indeed, does not constitute any "put, call, option or other right or obligation to buy . . . or sell securities":

> "2. The right of a pledgee or borrower of securities to sell the pledged or borrowed securities is not an option or right to sell securities within the meaning of this section. However, the sale of the pledged or borrowed securities by the pledgee or borrower shall be reported by the pledgor or lender."

Rule 16a-6 thus requires that the sale out of pledge be considered a transfer by the pledgor, who must make appropriate ownership filings, not a transfer by the pledgee, who is not the owner.

In sum, neither a pledge of stock as security for a loan nor the release of such a pledge upon repayment is a "purchase or sale" of the stock in the realities of commerce or within the meaning of the 1934 Act. Simple definitional analysis and established canons of statutory construction require reversal of the holding below. While the clarity of the statutory language renders further inquiry unnecessary, *see Ernst & Ernst* v. *Hochfelder*, *supra* at 201; *United States* v. *Oregon*, 366 U.S. 643, 648 (1961), an analysis of congressional purpose and policy considerations also requires reversal.

II.

Congressional Purpose and Sound Policy Confirm that There Is No Warrant for Judicial Extension of § 10(b) to Pledge Transactions.

The language of a statute is presumed to have its ordinary meaning, and a party asserting otherwise must make a clear showing that the legislation requires a different interpretation. As expressed by Judge Friendly in *SEC* v. *Sterling Precision Corp.*, 393 F.2d at 218:

> "A party asserting that a word in a statute should be given a meaning different from what it has in the speech of common men or, in this instance, the common speech of lawyers, has the burden of showing that context or evident p[illegible]se requires this."

Here, both the "evident purpose" of the 1934 Act and its general legislative context confirm the presumption that the words "purchase" and "sale" are to be given their "commonly accepted" meanings.

The 1934 Act was not intended to establish a federal commercial law, but rather to provide relief for particular problems of the investing public. *See Santa Fe Industries*

v. *Green*, 97 S. Ct. 1292, 1303-04 (1977). The Act was "chiefly concerned with the regulation of post-distribution trading on the Nation's stock exchanges and securities trading markets." *Blue Chip Stamps*, *supra* at 752; *see id.* at 728.

The pledgor-pledgee relationship involves no use of stock exchanges and has no effect on trading markets. The stock markets are involved only if the pledged securities are sold upon default, and such sales are, of course, subject to § 10(b)'s proscriptions as between the purchaser, on the one hand, and the pledgor and his agent, the pledgee, on the other.

Nor was there any need for Congress to extend § 10(b) to pledges in order to effectuate its antifraud purposes. The parties to a pledge transaction are situated quite differently from purchasers and sellers of securities in terms of legal recourse under state law. In the event that the pledgor fails to repay the loan and the pledged securities prove to be worthless, the pledgee need not resort to a common-law fraud action. He has a direct and simple action against the pledgor on the unpaid note. And a pledgor, unlike a seller of securities, cannot be the victim of any securities fraud by the pledgee, because the stock, or its proceeds, still belongs to the pledgor. Misappropriation of the collateral by a pledgee in possession is no more a securities fraud than would be a robbery of a brokerage house. The pledgor simply maintains a straightforward action for conversion.[8]

The purpose of Congress in enacting § 10(b) thus had nothing to do with regulating pledge transactions. It is clear as well that Congress enacted the various securities legislation of the 1930's to accomplish specific objectives, and when Congress needed to impose special definitions

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[8] *See Meisel* v. *North Jersey Trust Co.*, 218 F.Supp. 274, 278 (S.D.N.Y. 1963).

upon common words in order to attain these objectives, it did so. In the Public Utility Holding Company Act of 1935, for example, Congress prescribed a broad definition of "sale" specifically to include pledges as well as leases. 15 U.S.C. § 79b(a)(23). In that Act Congress sought to regulate all substantive business transactions among utility affiliates and holding companies to avoid manipulation of profits and losses, *see, e.g.*, 15 U.S.C. § 79*l*, and chose its language to that end. In the 1934 Act, on the other hand, Congress regulated securities trading, not a broad range of commercial transactions, and required no more than the "commonly accepted" definitions of "purchase" and "sale" to achieve fully its purposes.

In declining to construe "sale" under § 10(b) to include offers to sell, the Court in *Blue Chip Stamps* contrasted § 10(b) with § 17(a) of the 1933 Act, which expressly includes both the "offer" and "sale" of securities. *Id.* at 733-34 & n. 5; *id.* at 756. The contrast between the definitions of "sale" in the 1934 Act and in the Public Utility Holding Company Act of 1935 similarly precludes judicial substitution of the latter's broad definition in the 1934 Act, which is a "carefully drawn statute [that] itself defines the term 'sale.'" *Id.* at 733 n. 5.

Congress by the 1934 Act did not seek to regulate commercial loans, and there is no basis for distinguishing unsecured loans from secured loans, whatever the collateral. As Professor Loss aptly has noted, "federal legislation was hardly needed for privately negotiated pledge transactions between borrowers and lenders." 1 L. LOSS, SECURITIES REGULATION 649 (2d ed. 1961).

The inevitable consequence of extending the scope of § 10(b) to pledge transactions would be a rash of vexatious litigation by borrower-pledgors seeking any means

possible to avoid financial reversals.[4] The delay value alone of such frivolous actions, where the plaintiffs would be freed from the constraints of the statute of frauds and other proven limitations under state law, would be substantial, without any corresponding increase in protection afforded the parties to the pledge transactions. *See Blue Chip Stamps, supra* at 741. The adjudication of such claims, which are totally devoid of any connecting link with the securities laws, would be a vast waste of judicial energy. The defense of such actions would likewise impose an unnecessary and costly burden on lending institutions and thereby restrict the availability of credit or add to its cost.

If the legal regime governing commercial loans, which evolved from the common law and statutory draftsmen over hundreds of years, is to have a divergent provision of federal law such as § 10(b) superimposed upon it, that decision should be made by Congress, not the courts.

III.

The Decision Below Was Unsupported by Reasoned Analysis.

The court below ignored this Court's teachings as to statutory construction by failing to accord the terms "purchase" and "sale" their "commonly accepted" mean-

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[4] Among the claims that pledgors have sought to assert under § 10(b) are that the pledgee promised that the pledgor-borrower could have time to find a purchaser for the collateral, *Dopp* v. *Franklin National Bank*, 461 F.2d 873 (2d Cir. 1972); that the pledge was induced through misrepresentations, *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); that the issuer reneged on a promise to register the shares so as to maximize the proceeds on a default sale, *Devonbrook, Inc.* v. *Lily Lynn, Inc.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,621 (S.D.N.Y. 1974); that the pledgee made an unfair loan to the pledgor to the detriment of the guarantor, *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975).

ings. Its only apparent reason for doing so was its erroneous postulate, adopted from an earlier decision under § 17(a) of the Securities Act of 1933, that pledgees assume an " 'investment risk . . . identical in nature to the risk taken by investors' " (A163, quoting *United States* v. *Gentile*, discussed at pp. 14-15, *infra*).[5]

Contrary to the conclusion of the court below, a pledgee is a lender, with recourse against all the pledgor's assets, not an "investor" in specific assets. The pledge of stock as security for a loan is truly "collateral" to the loan transaction, and does not transform the loan into a securities investment any more than the acceptance of a pledge of receivables from a retailer places a commercial lender in the business of retailing. Far from assuming an "identical" "investment risk," the pledgee receives no benefit from appreciation of a security, and his risk from depreciation does not affect the right to repayment but is merely one of numerous factors, the most important of which is the pledgor's overall financial condition, which affect the ease of repayment.[6]

In support of its holding the court of appeals cited two cases decided under the Securities Act of 1933, *SEC* v. *Guild Films Co.*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960) and *United States* v. *Gentile*, 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976), which had broadly opined that all pledges were "sales" under that Act. Neither of these decisions provides more solid

[5] In an effort to distinguish *Blue Chip Stamps*, the court also stated that a "pledge . . . is just as concrete a transaction as is a normal transfer of title" (A164). While this statement is of course true in terms of whether the existence of the pledge transaction is susceptible to objective proof, it begs the question of whether a pledge, which does not involve the transfer of title or ownership, is nonetheless a "sale."

[6] Prudent and normal banking procedures mandate that the overall financial health of the borrower—not the existence of collateral—should be the first and most important criterion in decisions to extend credit.

support for the decision below than the court's own mistaken view of the nature of a pledge.

Guild Films involved a scheme by a bank and its debtor to distribute unregistered securities to the public and utilize the proceeds to satisfy a pre-existing debt. The district court found as fact that the "pledge" to the bank was a subterfuge sale to avoid the registration requirements of the 1933 Act and rightly enjoined the distribution at the instance of the SEC. 178 F. Supp. 418, 424 (S.D.N.Y. 1959). The court of appeals unnecessarily went much further, however, and asserted that all pledges of unregistered securities would be deemed "sales" for the purpose of distribution and all pledgees deemed statutory underwriters.[7] 279 F.2d at 489-90.

Guild Films has been roundly criticized regarding both its requirement of registration by pledgees[8] and its dictum as to pledges being sales.[9] Most lower courts con-

[7] Guild Films relied on the statutory definition in § 2(3), 15 U.S.C. § 77b(3), which defines "sale" as including "every . . . disposition of a security or interest in a security, for value," which is broader language than the 1934 Act definition. 279 F.2d at 489. *See Blue Chip Stamps*, *supra* at 733 n.5. But, as with the definition of "sale" in the 1934 Act, there is no indication of a congressional intent to alter the ordinary meaning of the word "sale" to include pledge transactions.

[8] *See* 1 L. Loss, Securities Regulation 645-51 (2d ed. 1961); Pierce, *Securities and Exchange Commission* v. *Guild Films Co. Inc.*, 16 Bus. Law. 603 (1961), citing Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 Law & Contemp. Prob. 89, 124 (1937). *But see SEC* v. *Dolnick*, 501 F.2d 1279, 1283 (7th Cir. 1974); *SEC* v. *National Bankers Life Ins. Co.*, 334 F. Supp. 444, 456 (N.D. Tex. 1971), *aff'd*, 477 F.2d 920 (5th Cir. 1973).

[9] *See Investment Properties Int'l, Ltd.* v. *I.O.S. Ltd.*, [1970-1971] Fed. Sec. L. Rep. (CCH) ¶ 93,011 (S.D.N.Y. 1971):

"[P]laintiffs argue that the pledge should be deemed a 'sale,' and that the pledgee is a 'purchaser' for purposes of § 10(b)

(footnote continued)

sequently have declined to extend *Guild Films* to hold that a pledge is a "sale" for purposes of § 10(b) of the 1934 Act.[10]

The other case relied upon by the court below, *United States* v. *Gentile*, held that a pledge constituted a "sale" for the purpose of criminal prosecution under § 17(a) of the 1933 Act The *Gentile* opinion noted that *Guild Films* was "primarily intended to protect investors," but

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and Rule 10b-5. For this proposition plaintiffs rely upon *SEC* v. *Guild Films* . . ."

* * *

"The uncertain scope of Guild Films has been noted. *See Fox* v. *Glickman Corporation*, 253 F. Supp. 1005, 1011-12 (S.D.N.Y. 1966), and authorities cited therein. This court concludes that where the pledgee seeks the label of "purchaser" for its own advantage rather than the satisfaction of some regulatory protection of others, where the collateral is taken at the initial making of the loan in circumstances suggesting that there was no initial intent to foreclose on the pledge or effect a distribution, and where there has in fact been no foreclosure and no attempt at distribution, the mere pledge of the shares of a foreign corporation is not a purchase or sale of securities within the context of § 10(b)."

[10] While lower courts have found varied bases to dismiss the claims, their analyses suffer from having to contend with the overbroad language of *Guild Films*. *See McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d at 495-96 (holding that a pledge itself is not a "sale" but reserving decision as to whether a sale out of pledge to a third party might be a "sale" as between pledgor and pledgee):

"A commercial bank's business is lending money not trading in securities. . . . [M]ere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview."

Herpich v. *Wallace*, 430 F.2d 792, 811-12 (5th Cir. 1970) (*Guild Films* has no applicability under § 10(b)); *Bronner* v. *Goldman*, 361 F.2d 759, 762 (1st Cir.), *cert. denied*, 385 U.S. 933 (1966) (*Guild Films* applies only to definition of underwriter under 1933 Act); *Devonbrook, Inc.* v. *Lilly Lynn, Inc., supra* (no action under Rule 10b-5 by pledgor because no possible causal link); *Rosen* v. *Dick*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 at 96,605 (S.D.N.Y. 1974) (pledge not a "sale"; sale out of pledge upon default is a sale).

based its holding on the extraordinary, unsupported assertion that "there is no reason to doubt that Congress intended that Act to protect defrauded lenders just as much as defrauded buyers." 530 F.2d at 467.

Thus, neither of the decisions relied upon by the court below was based on analysis more substantial or persuasive than its own so far as § 10(b) of the 1934 Act is concerned. The absence of a reasoned basis for the decision below is finally and most clearly manifested by its internal contradiction. With respect to other defendants, the court held that plaintiffs could not invoke § 7 of the 1934 Act and Regulation U thereunder *because plaintiffs, as pledgees, did not "purchase" any stock—precisely the opposite of the holding reached later in the opinion as to plaintiffs' status under § 10 (b).* The 1934 Act's definition of "purchase" applies equally to § 7 and § 10(b), and if a pledge is not a "purchase" under § 7 it is not a "purchase" under § 10(b).

Conclusion

For the reasons stated, the judgment should be reversed.

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In the Supreme Court of the United States

OCTOBER TERM, 1977

BANKERS TRUST COMPANY, PETITIONER

v.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN

MOTION OF THE UNITED STATES FOR LEAVE TO FILE A BRIEF AMICUS CURIAE

WADE H. MCCREE, JR.,
Solicitor General,
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Washington, D.C. 20530.

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The Solicitor General, on behalf of the Securities and Exchange Commission, moves this Court for leave to file a brief as *amicus curiae* after the time limit specified by Rule 42(2). Cf. Rule 42(4).

This Court granted certiorari on May 23, 1977. Petitioner's brief was filed on August 18, 1977. Respondents obtained an extension for filing their brief to October 10, 1977, but filed their brief on September 28, 1977.

The Commission's brief supporting the respondents' position addresses a number of points raised by petitioner Bankers Trust and *amicus curiae* Clearing House but not answered by the respondents. The Commission's brief discusses the nature of a pledge transaction and its similarities to an outright sale,

analyzes the case law relating to pledges in both the civil and the criminal context and distinguishes this case from *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723. Furthermore, the Commission's brief, unlike that of the respondents, addresses not only the issues raised by this particular transaction but the consequences that this Court's decision may have on securities transactions generally and upon private litigation, civil enforcement cases brought by the Commission, and criminal proceedings. For these reasons, the brief would be helpful to the Court in analyzing and deciding the case.

The record in this litigation is confusing and, in some places, conflicting. This is so because the district court incorporated into its record the papers filed by one of the respondents in an earlier state court action. The original district court complaint did not contain an allegation of fraud, the present theory of this action. While the state court papers did allege fraud, the fraud was there alleged to have been committed through nondisclosure. Subsequently, respondents alleged in the district court that the fraud was committed through misrepresentation. Due to this state of the record, it was difficult for the Securities and Exchange Commission to determine the precise nature of the issues involved in this litigation and, hence, to decide whether it should participate as *amicus curiae* before this Court.

Because of the difficulty described above, the members of the Commission considered this case on two

occasions (August 25 and September 19) before requesting the Solicitor General to file a brief. On September 30, the Commission sent its draft to the Office of the Solicitor General. There was extensive discussion between lawyers in this Office and the Commission staff, and the draft brief was further revised. This process took substantially longer than anticipated. A page proof of the brief was served by mail upon petitioner's counsel on November 3, 1977, and a revised proof was served on them on November 7, 1977.

WADE H. MCCREE, JR.,
Solicitor General.

NOVEMBER 1977.

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

It is important to the Securities and Exchange Commission that a pledge of securities as collateral for a loan be construed as a "sale" of those securities under the antifraud provisions of the federal securities laws, so that civil and criminal enforcement proceedings may continue to be brought where fraud is committed in connection with such pledges and so that, as here, the victim of the fraud may maintain an action for damages. The Commission has successfully brought civil proceedings, and there has been at least one successful criminal prosecution, based upon fraud committed in connection with a pledge of securities. Private rights of action are an important aspect of the

enforcement of the federal securities laws, providing a "necessary supplement" to the enforcement actions of the Commission. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432.

The Commission is concerned about the scope of the antifraud provisions of the federal securities laws and the injury to investors it believes would result if the Court adopted the restrictive interpretation of those provisions that petitioner and the *amicus curiae* New York Clearing House Association urge. For the reasons that follow, the Commission submits that a pledge of securities as collateral for a loan is a "sale" under Section 10(b) of the Securities Exchange Act of 1934 and the Commission's Rule 10b-5 thereunder.

STATEMENT[1]

In this private action alleging a violation of antifraud provisions of the federal securities laws, respondents Samuel Mallis and Franklyn Kupferman claim that petitioner Bankers Trust Company ("Bankers Trust") fraudulently induced them to accept from third parties certain shares of stock as collateral for a loan, even though Bankers Trust knew the stock was worthless.

In February, 1972, Jack Arnold and John Fowler, as co-venturers, agreed to purchase from Jerome Kates and Judith Kates 40,384 shares of common

[1] Since the district court dismissed the complaint on the ground that respondents lacked standing to maintain the suit, the respondents' allegations are deemed to be true for purposes of this Court's review, and should be construed in a light most favorable to the respondents. See, *e.g.*, *Conley* v. *Gibson*, 355 U.S. 41, 45-46; *Scheuer* v. *Rhodes*, 416 U.S. 232, 236.

stock of Equity National Industries, Inc. ("Equity National") (App. 16, 23-25).[2] The Kateses previously had pledged the stock to petitioner Bankers Trust as collateral for a $50,000 loan, of which some $45,000 was outstanding at the time of the purchase agreement (App. 56-57). The Kateses intended to redeem the stock from Bankers Trust by repaying the loan with the proceeds received from the sale of the stock to Arnold and Fowler (App. 59-60).

Arnold and Fowler arranged to obtain the funds for the purchase by borrowing $156,000 from respondents Mallis and Kupferman. Arnold and Fowler agreed to repay them $156,000, plus a $50,000 fee, within 30 days. To secure this loan, Arnold and Fowler agreed to pledge the Equity National stock to Mallis and Kupferman (App. 49).

The certificates for the Equity National stock (in Bankers Trust's possession as collateral for the loan

[2] "App." refers to the appendix in this Court.

Following the events leading to this suit, but before this suit was brought, respondent Mallis filed an action in the New York Supreme Court against petitioner Bankers Trust, the Kateses, Fowler, Arnold, Equity National and others (App. 63-76). The affidavits and pleadings in that action were incorporated by reference in Bankers Trust's affidavit in support of summary judgment (App. 53) and hence were before the district court and are included in the appendix filed in this Court. The state court action was dismissed before the present suit was filed (App. 88-92).

to the Kateses) stated that the shares were subject to an escrow agreement between Equity National and the Kateses. The agreement permitted Equity National to cancel the shares if a corporation it had acquired from the Kateses in a merger failed to achieve a specified level of earnings within a specified time (App. 44–45).

In March and April 1971 (a year prior to the present transaction), Equity National wrote to Bankers Trust, recalling the shares for cancellation (App. 95–98). Bankers Trust refused to return the shares (Br. App. 53).[3]

A closing on the transaction here was held on March 3, 1972, at the offices of Bankers Trust. Arnold and Fowler, the Kateses, and a representative of Mallis and Kupferman attended it (App. 10, 59, 79). Jerome Kates there delivered to Arnold, at the latter's request, an affidavit stating that, notwithstanding the legend on the Equity National shares, the stock had been released from the escrow agreement and was freely negotiable (App. 75). This representation by Kates, however, was untrue and Bankers Trust knew it was untrue (App. 110). In fact the stock was void and worthless (App. 68, 75–76, 135). Bankers Trust, which was anxious that the Kateses should sell the stock and so obtain funds to repay the loan (App. 68), either remained silent or affirmatively stated that the stock was no longer subject to the restrictive legend.[4]

[3] "Br. App." refers to the Appendix to the petitioner's brief.

[4] The pleadings and supporting affidavits are unclear whether Bankers Trust's representative remained silent or actually misrepresented the status of the stock. The original complaint alleged, as against Bankers Trust, only that it violated the Securities Act of 1933 and contained no allegation of fraud and no claim concerning Bankers Trust's actions at the closing (App. 11; note 5, *infra*). The earlier state court action, whose pleadings and supporting documents were before the district court, see note 2, *supra*, alleged that Bankers Trust's role in the fraud was that it "remained silent" (App. 68, 75).

An affidavit of Mallis and Kupferman submitted to the district court in opposition to the motion to dismiss stated that Bankers Trust "withheld vitally material information from us and our representatives and, as we are informed, actually misrepresented that the securities in question were genuine when in fact they were not" (App. 110). The motion to amend the complaint to include a Section 10(b) and Rule 10b–5 claim against Bankers Trust (see p. 6, *infra*) was made "[d]uring the course of proceedings in the district court" (App. 158). The court described the claim as alleging that Bankers Trust "orally assert[ed]" that the certificates were no longer subject to the escrow agreement (App. 135). The court of appeals likewise stated that the theory of the claim was that Bankers Trust "knowingly misrepresented" that the certificates were no longer subject to the escrow agreement (App. 159).

We will refer herein to Bankers Trust's conduct at the closing as "misrepresentation." Affirmance by this Court of the court of appeals' judgment will merely allow Mallis and Kupferman to amend their complaint to allege a cause of action under Section 10(b) and Rule 10b–5; it would not amount to a ruling that Bankers Trust affirmatively misrepresented any fact or that simple nondisclosure alone would be a violation of Section 10(b) and Rule 10b–5 on the facts of this case. See App. 165.

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Upon Arnold's receipt of the affidavit, Mallis' and Kupferman's agent made out at least two checks totalling $156,000 and handed them to the Kateses, who in turn endorsed to Bankers Trust one such check for $45,000 as the amount due on their loan (App. 60). Bankers Trust thereupon returned the shares, which it had held as collateral, to the Kateses, who immedi-

ately transferred them to Arnold and Fowler (App. 157–158). Shortly after the closing, Arnold and Fowler delivered the shares to Mallis and Kupferman, who, in accordance with their prior agreement, were to hold them as pledgees (App. 71, 76, 158).

Arnold and Fowler defaulted on their agreement to repay Mallis and Kupferman, who then discovered that the securities they held as collateral were void. Mallis and Kupferman instituted the present suit in the United States District Court for the Southern District of New York against Bankers Trust and others (App. 6). The allegations against Bankers Trust in the complaint—allegations not involving fraud[5]—were later abandoned (App. 156), and the respondents sought to amend the complaint to assert a claim that Bankers Trust had violated Section 10(b) of the Securities Exchange Act of 1934 and the Commission's Rule 10b–5 thereunder by representing that Kates' affidavit was true (App. 159). See note 4, *supra*.

On the basis of pleadings and affidavits in a similar state court action incorporated into the present case (see note 2, *supra*), the district court dismissed the claim against Bankers Trust for lack of jurisdiction

[5] Mallis and Kupferman alleged that Bankers Trust violated the "Securities Act of 1933" by accepting the Equity National stock as collateral for the loan to the Katems and by later transferring the stock to Mallis and Kupferman "or their nominee." Mallis and Kupferman did not specify which sections of the Securities Act of 1933 allegedly prohibited these transactions (App. 10–11).

over the subject matter and failure to state a claim upon which relief could be granted (App. 137).[6] The court also denied Mallis' and Kupferman's motion to amend their complaint to assert a claim under Section 10(b) and Rule 10b–5, holding that, as pledgees, they were not "purchasers" of the Equity National stock "within the requirement of the Birnbaum doctrine"[7] and could "not state a claim entitling relief under Rule 10b–5 * * * since no purchase or sale was involved." The court rejected the claim that a pledge of stock is a sale for purposes of Section 10(b) and Rule 10b–5 (App. 134).

The court of appeals reversed the dismissal and remanded with directions to allow Mallis and Kupferman to amend their complaint to assert a claim under Section 10(b) and Rule 10b–5. The court held that, as pledgees, they had standing to sue under Section 10(b) and Rule 10b–5, since the pledge constituted a sale under the antifraud provisions of the Securities Exchange Act (App. 165).

SUMMARY OF ARGUMENT

The Securities Exchange Act of 1934 defines a "sale" to "*include* any contract to sell *or otherwise*

[6] To finance the transaction, Mallis and Kupferman borrowed $156,000 from the Franklin National Bank (App. 7–8), which is now insolvent. The district court dismissed their claims against that bank and its successors (App. 6–9, 131–134), and the court of appeals affirmed (App. 160–162). Those claims are not before this Court.

[7] *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (C.A. 2), certiorari denied, 343 U.S. 956; see *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 749.

dispose of" (emphasis supplied). We submit that this broad language includes a pledge, as does the companion definitional section of the Securities Act of 1933, which defines "sale" to "include every contract of sale or disposition of a security or interest in a security, for value." "[T]he omission of the [latter] term • • • provides no basis for concluding that Congress intended to exclude" a pledge from the 1934 Act's coverage. Cf. *Tcherepnin* v. *Knight*, 389 U.S. 332, 344.

Because of the generality of the definition of "sale" in the 1934 Act, the primary focus in determining whether a particular transaction constitutes a sale within the meaning of Section 10(b) is not on the definition but on the broader issue whether the "alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule" (cf. *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467).

Fraud in the pledging of securities was meant to be forbidden by Section 10(b) of the Act and Rule 10b–5, just as fraud is prohibited by those provisions where there is an outright sale. In both cases the recipient of securities is induced to part with money in reliance on the value of the securities and in both cases he is vulnerable to fraud by the party transferring the stock to him. The recipient's basic inquiry is the same in each case: whether the value of the stock justifies committing the recipient's capital in reliance thereon. In each case he is induced to acquire a significant interest in the stock in return for the outlay of

capital. "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions." *United States* v. *Gentile*, 530 F. 2d 461, 467 (C.A. 2), certiorari denied, 426 U.S. 936. Protection against fraud should not be relaxed merely because the pledgee's interest is not a permanent one. The argument that the pledgee has the right to seek repayment from the pledgor's other assets if the pledgor defaults ignores the very purpose of collateral—to enable the lender to obtain repayment of the loan without having to look to the borrower's other assets. The presumed value of the Equity National stock here induced Mallis and Kupferman to make the loan to Arnold and Fowler.

Whether a pledge is considered a purchase under state law is not determinative of the scope of protection of the federal securities laws, but in any event pledges have been treated as sales under the Uniform Commercial Code and state blue sky laws. Federal courts as well have repeatedly held that a pledge of securities is a sale under both the Securities Exchange Act of 1934 and the Securities Act of 1933. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F. 2d 490, 495 (C.A. 5), certiorari denied, 420 U.S. 930, stated that "a pledge of securities can constitute a 'sale' in some cases," but concluded that "the pledge was not a sale in the circumstances of this case." That narrow holding was erroneous, however, because it wrongly assumed that Section

10(b) and Rule 10b–5 reach only transactions which affect the securities industry, and because it concluded that fraud could be actionable only if the pledgee foreclosed on the collateral.

Affirmance of the judgment below would not intrude on state law nor would it subject the federal courts to a plethora of litigation, as petitioner fears. This case involves a charge of fraud similar to that which the Act and the Rule have been recognized as prohibiting for many years, and a pledgee in a 10b–5 action would still have to prove all elements of the offense, not simply that a pledge took place, in order to recover.

The holding of the court of appeals is not inconsistent with *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723. *Blue Chip* held that an offeree of stock who decided not to purchase could not later maintain that its decision not to act was fraudulently induced by the offeror. Here the situation is reversed. Mallis and Kupferman allege that Bankers Trust's fraud induced them to take affirmative action—to make a substantial loan—which they would not otherwise have taken. The dangers which *Blue Chip* foresaw in the context of rejected offers to sell do not apply to this case, since a pledge by its nature is a transaction subject to proof very much like an outright sale. Claims of fraud in the pledge of securities present factual issues of the type that courts and juries customarily have been deciding in securities fraud cases for years.

ARGUMENT

A PLEDGE OF SECURITIES AS COLLATERAL FOR A LOAN IS A "SALE" UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND THE COMMISSION'S RULE 10b–5 THEREUNDER

A. The definition of "sale" in the Securities Exchange Act of 1934 covers a pledge of securities as collateral for a loan.

Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b), makes it "unlawful for any person * * * [t]o use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules * * * as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The Commission's Rule 10b–5, 17 C.F.R. 240.10b–5 (Pet. Br. 40–41), generally prohibits fraud or misrepresentation "in connection with the purchase or sale of any security." The Act itself attempts no all-encompassing definition of either "purchase" or "sale," but provides that "purchase" "include[s] any contract to buy, purchase or otherwise acquire," and that "sale" "include[s] any contract to sell or otherwise dispose of." Section 3(a)(13), (14), Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(13), (14) (Pet. Br. 40).

The definitional sections of the Securities Exchange Act of 1934, although "for the most part unhelpful,"

"do indicate the breadth of the statutory terms by using the definitional word 'include' and by including within the definitions contracts 'to buy, purchase, or otherwise acquire' and 'to sell or otherwise dispose of' securities" (*Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 466, 467, n. 8). The word "include" indicates that the listed categories are not exclusive, and the words "or otherwise acquire" and "or otherwise dispose of" show that the statute applies to transactions in addition to those the words "buy" or "sell" directly cover.

When the owner of securities pledges them as collateral for a loan, he is "disposing of" these securities. The disposition initially is only temporary, until the loan has been repaid. It may become permanent, however, if the pledgor defaults on the loan and the lender forecloses on the collateral. There is nothing in the statute requiring that for there to be a sale the disposition must be complete and permanent. It is enough to trigger the application of the antifraud provisions that the owner of securities has disposed of an interest in them in a transaction in which the person acquiring the interest is likely to be influenced by misrepresentations or failure to disclose material facts by the owner.

This is confirmed by the companion definitional section of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a *et seq.*, which also contains antifraud provisions covering sales of securities. That section defines "sale" to "include every contract of sale or disposition of a security or interest in a security, for value." 15 U.S.C. 77b(3). When a borrower pledges securities with a lender as collateral for a loan, he is disposing of an "interest in a security, for value." Although the definition of "sale" in the 1934 Act does not contain the words an "interest in a security," "the omission of the term * * * provides no basis for concluding that Congress intended to exclude" a pledge from the 1934 Act's coverage[8] (*Tcherepnin* v. *Knight*, 389 U.S. 332, 344; see also, *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151; *Sanders* v. *John Nuveen & Co., Inc.*, 463 F. 2d 1075, 1078 (C.A. 7)).[9]

[8] Bankers Trust (Br. 20) and the Clearing House (Br. 10) point to the fact that the Public Utility Holding Company Act of 1935, unlike the Securities Exchange Act, expressly includes a "pledge" within the definition of "sale" (Section 2(a)(23), 49 Stat. 809, 15 U.S.C. 79b(a)(23)). But this fact does not, as they contend, demonstrate that Congress intended to exclude pledges from the definition of sale in the Securities Exchange Act. In enacting the Holding Company Act, Congress imposed detailed substantive regulation on the disposition of securities, and necessarily gave particular attention to the various means by which a disposition could occur and, accordingly, specifically mentioned a pledge. In the Securities Exchange Act, on the other hand, Congress was concerned with the prevention of fraud in securities transactions generally, and there was no need to enumerate the variety of forms a disposition could take. It chose instead to adopt broad provisions against fraud by those who "dispose of" securities. See *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. at 466, 467 n. 8; *Tcherepnin* v. *Knight*, *supra*, 389 U.S. at 344.

[9] The Court of Appeals for the First Circuit has viewed the difference between the definitions of "sale" in these two Acts as insignificant, stating:

"Section 3(a)(14) of the Securities Exchange Act contains neither the 'for value' limitation of Section 2(3) of the Securities

B. The antifraud provisions of the Securities Exchange Act of 1934 were intended to cover fraud in connection with the pledge of securities as collateral for a loan.[10]

1. Because of the generality of the definition of "sale" in the 1934 Act, the primary focus in determining whether a particular transaction constitutes a sale within the meaning of Section 10(b) is not on the definition, but on the broader issue whether Bankers Trust's "alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule" (cf. *Securities and Exchange Commission* v. *National Securities, Inc., supra,* 393 U.S. at 467). In making that inquiry, it must be remembered that "remedial legislation"—into which category "[t]he Securities Exchange Act quite clearly falls"—"should be construed broadly to effectuate its purposes" (*Tcherepnin* v. *Knight, supra,* 389 U.S. at 336).

Act nor the conclusive presumption of value provision. We have no reason to believe that Congress intended, one year after the passage of the Securities Act, to dilute the concept of 'sale' in the Securities Exchange Act. [Citation omitted.] The 'otherwise dispose of' language of Section 3(a)(14) * * * [is] * * * 'hardly limiting.' Thus, the transaction in this case constitutes a sale within Section 3(a)(14) as well as Section 2(3)." *Lawrence* v. *Securities and Exchange Commission*, 398 F.2d 276, 280 (C.A. 1).

[10] The importance of the application of the antifraud provisions of the Securities Exchange Act to pledges is underlined by congressional recognition, in the legislative history of the Securities Acts Amendments of 1975, that pledging of fraudulently-issued, stolen or worthless securities as collateral for loans is a commonly

"A fundamental purpose" of the Securities Exchange Act and of the other federal securities laws was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* * * *." *Securities and Exchange Commission* v. *Capital Gains Research Bureau,* 375 U.S. 180, 186. In that case this Court noted that "Congress intended * * * securities legislation 'enacted for the purpose of avoiding frauds'" to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Id.* at 195 (footnote omitted). And see *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151.

The requirement of disclosure is no less important when the owner of securities offers them as collateral for a loan than when he offers to dispose of them completely. In both instances the recipient of the securities is induced to part with money in reliance on the alleged value of the securities.

In deciding whether to accept the Equity National stock as collateral for the loan they were making, Mallis and Kupferman had to make the same kind of judgment with respect to the value of that stock that they would have had to make in deciding whether to

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used method for disposing of such securities. See, Hearings on Organized Crime—Stolen Securities, before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 92d Cong., 1st Sess. 2 (1971); Hearings on Organized Crime—Securities: Thefts and Frauds, before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 93d Cong., 1st Sess. 7 (1973); 121 Cong. Rec. 10733 (1975).

purchase it outright. Although the purpose of evaluating the stock would be different in these two situations, in each instance the basic inquiry was the same: whether the value of the stock warranted committing their capital in reliance thereon. The impact upon Mallis and Kupferman of Bankers Trust's alleged fraud was no less because they accepted the stock as collateral for a loan they gave instead of purchasing it outright.

Mallis and Kupferman certainly would not have made the loan had they known that the collateral designed to secure it was merely worthless paper because the securities the paper purported to represent had been cancelled by the issuer. Mallis and Kupferman were induced to acquire a significant interest in the stock, in return for which they parted with substantial capital, as a result of Bankers Trust's misrepresentation of critical information with respect to the value of the stock. This was precisely the kind of fraud that Congress intended to prohibit in Section 10(b).

Such misrepresentation of a highly significant material fact in connection with the sale of securities repeatedly has been held to constitute fraud under Section 10(b) and Rule 10b–5. *E.g., Mitchell* v. *Texas Gulf Sulphur Company,* 446 F. 2d 90 (C.A. 10), certiorari denied, 404 U.S. 1004; *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath,* 540 F. 2d 27 (C.A. 2); *Zabriskie* v. *Lewis,* 507 F. 2d 546 (C.A. 10). In view of Section 10(b)'s basic purpose of protecting investors (a category which includes lenders)

against fraud, the result should be no different because the "sale" of securities in connection with which the fraud was committed took the form of a pledge rather than a more permanent disposition.

As the Court of Appeals for the Second Circuit explained in *United States* v. *Gentile,* 530 F. 2d 461, 467, certiorari denied, 426 U.S. 936, in holding that a pledge of securities was a sale under the Securities Act of 1933:

> In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute.

Amicus Clearing House argues (Br. 12), however, that a pledgee does not assume the type of investment risk of an outright purchaser of securities. It contends that a pledgee has "recourse against all the pledgor's assets" and "his risk from depreciation [in the value of the pledged securities] does not affect the right to repayment but is merely one of numerous factors, the most important of which is the pledgor's overall financial condition, which affect the ease of repayment."

These circumstances, however, do not eliminate the pledgee's investment risk with respect to the securities. Although the degree of that risk may vary with the particular pledgor's financial condition, the

risk exists in every case. Since it is commonplace in the commercial world that substantial loans frequently are made without collateral, the very fact that the lender does require security shows that in the particular transaction the lender may be relying upon the collateral as protection for his loan. The argument that the pledgee has the right to seek repayment from the pledgor's other assets ignores the very purpose of collateral—to enable the lender to obtain repayment of the loan in the event of the borrower's default without having to look to the borrower's other assets.

In this case Mallis and Kupferman presumably were aware that Arnold's and Fowler's credit ratings were poor, since Arnold told Mallis that he would pay a $50,000 finder's fee for a loan of $156,000 (App. 16–17). In these circumstances, the fact that Arnold and Fowler offered them the Equity National stock as collateral must have induced Mallis and Kupferman to make the loan.[11]

[11] The court of appeals, in addition to holding that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler," stated that Bankers Trust was "a seller by virtue of its release" of the securities the Kateses had pledged (App. 165). The latter conclusion was unnecessary to the court's decision, since if Mallis and Kupferman were "purchasers," Bankers Trust's status as a seller *vel non* is irrelevant. A defrauded purchaser has a cause of action under Rule 10b–5 against "any person" who committed fraud "in connection with the purchase," regardless of whether that person is the seller. *E.g.*, *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F. 2d 963, 968 (C.A. 2). In *Heit* v. *Weitzen*, 402 F. 2d 909 (C.A. 2), certiorari denied, 395 U.S. 903, the plaintiff purchasers alleged that the defendant corporate officials had made material misstatements in the

2. Bankers Trust argues (Br. 14) that because "[b]oth at common law and under the Uniform Commercial Code, a 'pledge' of securities is not a 'purchase' or 'sale' * * * ," it should not be treated as a sale under the antifraud provisions of the federal securities law. But even if pledges were not sales under state law—which we dispute below—that would not preclude their being sales under the antifraud provisions of the federal securities laws. If "there [is] a 'sale' of a security and * * * fraud [is] used 'in connection with' it, there is redress under §10(b), whatever might be available as a remedy under state law." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12. As the Court of Appeals for the Seventh Circuit pointed out in *Dasho* v. *Susquehanna Corp.*, 380 F. 2d 262, 266, certiorari denied *sub nom. Bard* v. *Dasho*, 389 U.S. 977, in discussing the definitions of purchase and sale in the Securities Exchange Act:

> This broad language indicates an intention by Congress that the words "purchase" and "sale" are not limited to transactions ordinarily gov-

company's annual report, thus inflating the market price of its shares. The plaintiffs purchased their securities on the market and not from the defendants. The court of appeals held that the plaintiffs had alleged a cause of action under Rule 10b-5. It stated: "It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation." 402 F. 2d at 913. Consequently, Bankers Trust's argument (Br. 27–33) that is was not a "seller" for purposes of Rule 10b–5 is beside the point.

erned by the commercial law of sales. The purpose is evidently to make control of securities transactions reasonably complete and effective to accomplish the purposes of the legislation."[12]

In accord with this congressional intent, the terms "purchase" and "sale" have been held to cover a variety of transactions in securities cases, without regard to whether state law so characterized them. These include mergers,[13] issuance of stock,[14] forced sales,[15]

[12] Similarly, other courts have emphasized that the definition of "sale" must be construed liberally for purposes of the antifraud provisions. See, *e.g.*, *Spector* v. *L Q Motor Inns, Inc.*, 517 F.2d 278, 286 (C.A. 5), certiorari denied, 423 U.S. 1055; *Coffee* v. *Permian Corp.*, 434 F. 2d 383, 385 (C.A. 5), certiorari denied, 412 U.S. 920; *Herpich* v. *Wallace*, 430 F. 2d 792 (C.A. 5); *Knauff* v. *Utah Construction & Mining Co.*, 408 F.2d 958, 961 (C.A. 10), certiorari denied, 396 U.S. 831; *Mader* v. *Armel*, 402 F.2d 158, 160 (C.A. 6), certiorari denied *sub nom. Young* v. *Mader*, 394 U.S. 930; *Lawrence* v. *Securities and Exchange Commission*, *supra*, 398 F.2d at 280.

[13] *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*; *Smallwood* v. *Pearl Brewing Co.*, 489 F. 2d 579, 591 (C.A. 5), certiorari denied, 419 U.S. 873; *Vine* v. *Beneficial Finance Co.*, 374 F. 2d 627, 634 (C.A. 2), certiorari denied, 389 U.S. 970; *Dasho* v. *Susquehanna Corp.*, *supra*.

[14] *Schoenbaum* v. *Firstbrook*, 405 F. 2d 215, 219 (C.A. 2), certiorari denied *sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906; *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 202–203 (C.A. 5), certiorari denied, 365 U.S. 814.

[15] *Travis* v. *Anthes Imperial Ltd.*, 473 F. 2d 515, 522 (C.A. 8); *Crane Company* v. *Westinghouse Air Brake Company*, 419 F. 2d 787, 794 (C.A. 2), certiorari denied, 400 U.S. 822; *Vine* v. *Beneficial Finance Co.*, *supra*, 374 F.2d at 635.

and exchanges of shares."[16] This Court, in *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, rejected the contention that a fraudulently-induced merger did not involve a purchase or sale of securities by the defrauded shareholders, stating:

> The broad antifraud purposes of * * * [Section 10(b)] and * * * [Rule 10b–5] would clearly be furthered by their application to this type of situation. Therefore we conclude that Producers' shareholders "purchased" shares in the new company by exchanging them for their old stock. As the Court of Appeals for the Seventh Circuit has said, "This view does no violence to the statutory language, and is the present interpretation of the body which is responsible for the administration of the acts."

393 U.S. at 467–468, citing *Dasho* v. *Susquehanna Corp.*, *supra*.

In any event, Bankers Trust errs in contending that a pledge is not a sale under either the Uniform Commercial Code or other state law. The definition of Official Draft 1952) specifically includes a "pledge" (Section 1–201(32)). Section 3–302(4) of the Code gives the rights of a holder in due course to the purchaser of a limited interest—such as the interest of "a

[16] *Swanson* v. *American Consumer Industries, Inc.*, 415 F. 2d 1326, 1330 (C.A. 7); *Knauff* v. *Utah Construction & Mining Co.*, *supra*, 408 F. 2d at 961.

"purchase" in the Uniform
Commercial Code (A.L.I.

pledgee in a security transaction" (see Comment 5 to Section 3-302)—to the extent of the interest purchased."

Moreover, a pledge has been held to be a "sale" under a state blue sky law designed to prevent fraud in securities transactions. In 1932, prior to the enactment of the federal securities laws, the Court of Appeals for the Ninth Circuit, in *Cecil B. De Mille Productions* v. *Woolery*, 61 F. 2d 45, held that an assignment of royalty interests in oil and gas leases as collateral for a loan was a "sale" within the meaning of the California Corporate Securities Act, which

[17] The Clearing House asserts (Br. 3, 15) that there is an "internal contradiction" in the court of appeals' opinion, because the court, while holding Mallis and Kupferman to be purchasers for purposes of Section 10(b) and Rule 10b-5, stated (App. 161) that they were not "purchasing" stock "within the meaning of Regulation U." But the question before the court under Regulation U—which prohibits banks from extending credit in excess of the value of collateral to purchase stock on margin—was not whether Mallis and Kupferman were "purchasing." The court was dealing with the claim by Mallis and Kupferman that Franklin National Bank had extended credit to them in violation of Regulation U. But where the bank's customer does not pledge stock with the bank, that regulation is applicable only if the customer is "engaged principally, or as one of [his] important activities, in the business of extending credit for the purpose of purchasing or carrying margin stocks * * *." 12 C.F.R. 221.3(q). The court of appeals stated (App. 161):

"Since borrowing for the purpose of relending to enable others to purchase or carry margin stock was not one of [Mallis' and Kupferman's] 'important activities,' we hold that Regulation U does not apply to the Franklin National Loan."

That ruling is unrelated to the question whether Mallis and Kupferman were "purchasers" of the Equity National stock.

defined the term "sale" as including "every disposition, or attempt to dispose, of a security or interest in a security for value" (see 61 F. 2d at 50)—a definition almost identical to that contained in the Securities Act of 1933 (see pp. 12–13, *supra*). The court ruled that, since a pledgee has an "'interest in the thing pledged,'" it was "obvious" that the pledgor "'disposed' or attempted to dispose, of an 'interest in a security'" when it pledged securities as collateral for a loan. 61 F. 2d at 50. In enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress intended to expand the protection state blue sky laws gave to investors. See S. Rep. No. 47, 73d Cong., 1st Sess., p. 2 (1933).

3. In view of the foregoing principles and considerations, it is not surprising that the federal courts repeatedly have held that a pledge of securities is a sale under both the Securities Exchange Act of 1934 and the Securities Act of 1933. In *Securities and Exchange Commission* v. *Dolnick*, 501 F. 2d 1279 (C.A. 7), Dolnick had pledged stock of two corporations—Pig'N Whistle and another—as collateral for a bank loan, and "to secure" the loan had made false representations to the bank concerning the stock. The court held (*id.* at 1283) that these statements were "made in connection with the pledges of the stock of both corporations in a single transaction," and "they were in connection with the sale of Pig'N Whistle stock and therefore part of the violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) alleged in the complaint."

Similarly, in *United States* v. *Gentile,* 530 F. 2d 461 (C.A. 2), discussed *supra,* p. 17, the court upheld a criminal conviction for violating the antifraud provisions of the Securities Act of 1933, based upon the pledging with banks, as collateral for loans, of stock certificates on which the names of unauthorized persons had been written. The court ruled that the pledges were "sales" of securities under Section 17(a) of the Act, which prohibits fraud "in the offer or sale" of securities. In *Securities and Exchange Commission* v. *Dolnick, supra,* the court also held, as did the court in *American Bank & Trust Company* v. *Joste,* 323 F. Supp. 843 (W.D. La.), that a pledge of securities as collateral for a loan was a sale under both the antifraud and the securities registration provisions of the 1933 Act. Other cases have held that the acceptance by the lender of a pledge of securities as collateral was a "purchase" of the securities under the 1933 Act for purposes of the registration requirements of that Act.[18] *Securities and Exchange Commission* v. *Guild Films Co.,* 279 F. 2d 485 (C.A. 2), certiorari denied *sub nom. Santa Monica Bank* v.

[18] Those cases involved the question whether the lender was required to comply with the registration provisions, with respect to securities it had acquired as collateral, when it foreclosed on the collateral by selling the securities. The answer depended upon whether, by acquiring the collateral, the bank had "purchased from an issuer with a view to * * * the distribution of any security," which would have made it a statutory underwriter under Section 2(11) of the 1933 Act, 15 U.S.C. 77b(11), and thus ineligible for an exemption from the registration requirements in Section 4(1), 15 U.S.C. 77d(1).

Securities and Exchange Commission, 364 U.S. 819;[19] *Securities and Exchange Commission* v. *National Bankers Life Insurance Co.,* 334 F. Supp. 444, 456 (N.D. Tex.), affirmed, 477 F. 2d 920 (C.A. 5); cf. *Securities and Exchange Commission* v. *International Chemical Development Corp.,* 469 F. 2d 20 (C.A. 10).

McClure v. *First National Bank of Lubbock, Texas,* 497 F. 2d 490 (C.A. 5), certiorari denied, 420 U.S. 930, held that in the particular circumstances of that case a pledge of stock was not a sale of securities under Section 10(b) of the 1934 Act and Rule 10b–5. McClure had pledged her stock as collateral for a bank's renewal of a loan to a corporation which she and her ex-husband owned. She alleged that her consent to the original loan had been obtained through the representation that the corporation needed the money, but that her ex-husband used the money for personal purposes. The bank eventually foreclosed on the corporation's property, thus making the plaintiff's stock worthless. The court of appeals held that the plaintiff had not alleged a violation of the Act or the Rule.

The court did "not doubt that a pledge of securities can constitute a 'sale' in some cases," but con-

[19] Beginning with its submission in *Guild Films* the Commission repeatedly and consistently has argued that a pledge is a sale under both the 1934 and the 1933 Acts. Although Bankers Trust asserts (Br. 25) that the Commission "changed its position" in *Guild Films,* prior to that time "there had been no public pronouncement by the Commission" on the subject. 1 Loss, *Securities Regulation* 645 (2d ed. 1961).

cluded that "the pledge was not a sale in the circumstances of this case" (497 F. 2d at 495). The court stated (*ibid.*):

> A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. * * * If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself bring within the scope of the federal securities acts a transaction otherwise outside their purview.

The court also ruled that because the bank had not foreclosed on the pledged stock or sold it, the pledge did not constitute a "sale."

That ruling involved two errors:

(1) The scope of Section 10(b) is not limited to "'preserving the integrity of the securities markets,'" and "the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to [the Act's] coverage * * *." *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra,* 404 U.S. at 10, 12. Section 10(b) applies "even though the transaction is conducted directly between the buyer and seller" (*Hooper* v. *Mountain States Securities Corp.,* 282 F. 2d 195, 201 (C.A. 5), certiorari denied, 365 U.S. 814).

(2) It is irrelevant that the bank did not foreclose on the collateral. The critical question is what happened when the pledge was made, which was when the fraud took place, and not what happened later. The court of appeals in *Gentile* criticized this aspect of the *McClure* decision. 530 F. 2d at 467, n. 6.[20]

Moreover, for the reasons previously set forth in this brief, *McClure* is wrong because it fails to give sufficient weight to the language of the definitional provisions of the 1934 and 1933 Acts, and to the policy considerations indicating that a pledge of securities as collateral for a loan is a sale under the antifraud provisions of those Acts.[21]

4. Bankers Trust (Br. 31) and *amicus* Clearing House (Br. 8) argue that Congress did not intend the

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[20] Two district courts in the Second Circuit, relying on the same rationale as was used in *McClure*, held that a pledge was not a sale under Section 10(b) and Rule 10b-5. *Investment Properties International, Ltd.* v. *I.O.S., Ltd.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,011, p. 90,740 (S.D. N.Y.), and *Rosen* v. *Dick*, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,786, p. 96,605 (S.D. N.Y.). These cases are of dubious vitality in view of the Second Circuit's subsequent decision in *Gentile*.

[21] Bankers Trust, citing Commission Rule 16a-6 under the Securities Exchange Act, 17 C.F.R. 240.16a-6, erroneously asserts that the rules under that Act "recognize that a pledge of securities is not a sale" (Br. 24; see also Clearing House Br. 7). Rule 16a-6 provides that an insider's granting, acquisition or disposal of any "put, call, option or other right or obligation" to buy or sell securities is a change in beneficial ownership and must be reported under Section 16(a) of the Act. A note to that Rule provides that the right to sell securities pledged as collateral need not be reported (though any sale itself must be). The Rule deals with changes in beneficial ownership that must be reported. It does not address the question of whether a pledge is a sale and is unrelated to the coverage of the antifraud provisions.

Securities Exchange Act to substitute federal for state law in cases involving misrepresentation constituting fraud in connection with the pledge of securities as collateral for a loan. But the application of federal antifraud provisions here would in no way preempt or conflict with state law. Bankers Trust attempts (Br. 31–32) to analogize this case to *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, which held that a majority stockholder's effectuation of a short-form merger pursuant to Delaware law, designed to eliminate minority interests and done in alleged breach of the stockholder's fiduciary duty, did not violate Rule 10b–5.

In that case, unlike the present one, the fraud alleged was "neither deceptive nor manipulative" (430 U.S. at 474), but was instead "a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure"—a typical case of "corporate mismanagement * * * in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary" (*id.* at 476–477). The Court concluded that Rule 10b–5 does not extend to mere "internal corporate mismanagement" (*id.* at 479, quoting from *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 12).

The present case, however, does not involve charges of corporate mismanagement or a majority stockholder's unfair treatment of minority ones. Instead, it charges only a garden variety type of fraud, based

upon a misrepresentation of the type that courts traditionally have resolved. See *supra,* p. 16, *infra,* p. 34.

A holding that a pledge of securities is a sale under Section 10(b) and Rule 10b–5 would not subject the federal courts to "a plethora of litigation * * * when the loan goes bad and the debtor has pledged securities which are either sold or diminished in value as a result of shifts in the stock market," as Bankers Trust predicts (Br. 32). As we have shown (*supra,* pp. 23–25), there is substantial case authority that a pledge is a sale under both the 1934 and the 1933 Acts, but these decisions have not produced the litigation that Bankers Trust anticipates.

Moreover, before a pledgee could recover under Rule 10b–5, he would have to establish all the elements of the offense—including the misstatement or nondisclosure [22] or other fraudulent conduct, its materiality and the defendant's *scienter* (*Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185)—and also a causal connection between the defendant's misconduct and the plaintiff's injury. This Court's recognition that a pledgee is a purchaser would only give a pledgee standing to maintain a suit. It would not create the likelihood of widespread litigation against, or liability of, pledgors accused of fraud in connection with the pledging of securities as collateral. See, *e.g., Dopp* v. *Franklin National Bank,* 374 F. Supp. 904 (S.D. N.Y.) (pledgor

[22] At this stage of the litigation the question does not arise whether mere silence by Bankers Trust would be actionable under the Act and the Rule in the circumstances of this case. See note 4, *supra.*

had standing as seller of securities to sue under Section 10(b), but failed to state a claim on which relief could be granted); and see the discussion in Part C, *infra*.

5. Bankers Trust also argues that "Congress provided that banks were to be regulated *not* by the Securities Exchange Commission [*sic*], but by the Federal Reserve Board" (Br. 31), and it points to this Court's statement that the 1934 Act "'was enacted primarily to halt securities fraud, not to regulate banks'" (Br. 30, citing *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 157)." But the fact that the defendant in this case is a bank is fortuitous. The critical question is whether a pledge of securities as collateral for a loan is a sale under the antifraud provisions, not the identity of the person who allegedly committed the fraud. Furthermore, although banks probably are the most common pledgees in commercial transactions, other persons also receive pledges as collateral, as in the instant case, where the pledgees, Mallis and Kupferman, are individuals.

C. The holding of the court of appeals that a pledge is a sale is not inconsistent with Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723.

In *Blue Chip*, this Court held that the plaintiff, who had refrained from purchasing stock in alleged re-

[23] Bankers Trust's statement that "banks were specifically exempted from any provisions of the securities laws" (Br. 30) is erroneous. Securities issued by banks are exempt from the registration requirements of the Securities Act (Section 3(a)(2), 15 U.S.C. 77c(a)(2)), but not from that Act's antifraud provisions. See Section 17(c), 15 U.S.C. 77q(c).

liance upon misrepresentations by the offeror, had no standing to maintain an action for damages for violation of Section 10(b) and Rule 10b-5, because the plaintiff had not made a "purchase or sale" of securities. The Court ruled that only "actual purchasers and sellers of securities" could bring such an action (421 U.S. at 730, 731–732, 749). The Court stated that it was not dealing with a statute that "legislated the elements of a private cause of action for damages" (*id.* at 748), but with a judicially-created private right of action, which "will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.* at 749.

As the court of appeals pointed out in this case (App. 164), *Blue Chip* involved "a plaintiff who claimed that the defendant's misrepresentations caused it to refrain from purchasing securities." The gravamen of the plaintiff's complaint in *Blue Chip* was that it had refrained from acting. In the present case, on the other hand, Mallis' and Kupferman's complaint is exactly the opposite. They contend that Bankers Trust's fraud induced them to take affirmative action—to make a substantial loan—which they would not otherwise have taken.

The major considerations that led the Court in *Blue Chip* to limit the private right of action under Section 10(b) and Rule 10b-5 to actual buyers and sellers do not apply in this case. If, as we urge, a

pledge of securities as collateral for a loan is a "sale", there is no question that Mallis and Kupferman were purchasers of securities, that Arnold and Fowler (the pledgors) were sellers, and that Bankers Trust's misrepresentation was committed in connection with the sale. Moreover, in this case the Court will be determining the meaning of the statutory terms "purchase or sale of securities"—a determination which will affect the ability of the government and private persons alike to bring an action at all—rather than delimiting the contours of a judicially-created private right of action, as it did in *Blue Chip*.

The principal policy consideration the Court stressed in *Blue Chip* was the "danger of vexatiousness" if non-purchasers and non-sellers were permitted to maintain suits under Rule 10b–5 (421 U.S. at 739). It noted that "[t]he potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure may likewise exist in this type of case to a greater extent than they do in other litigation" (*id.* at 741); that in a suit based on the claim that the plaintiff had refrained from buying or selling securities, the outcome "will turn largely on which oral version of a series of occurrences the jury may decide to credit, and therefore no matter how improbable the allegations of the plaintiff, the case will be virtually impossible to dispose of prior to trial other than by settlement" (*id.* at 742); that the rule limiting plaintiffs to actual purchasers or sellers "separates in a readily demonstrable manner the group of plaintiffs who actually purchased or actually sold, and whose version of the

facts is therefore more likely to be believed by the trier of fact, from the vastly larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it" (*id.* at 743) and "limits the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates" (*id.* at 747). It pointed out that "dealing in the security [by actual purchasers or sellers], whether by way of purchase or sale, will generally be an objectively demonstrable fact in an area of the law otherwise very much dependent upon oral testimony" (*ibid.*), whereas "bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass" (*ibid.*).

These considerations are inapplicable where the fraud relates to the value of a security that has been pledged as collateral for a loan. The fact of the pledge ordinarily is demonstrable by objective evidence; pledges in a commercial situation usually are as well documented as outright purchases and sales. A pledgee who has been induced to make a loan through misrepresentation concerning the value of the pledged securities is not a mere bystander but has "dealt in the security to which the • • • representation, or omission relates" (421 U.S. at 747). Permitting him to sue would not create the danger of a large number of

strike suits in which possible liability would turn on the jury's assessment of the plaintiff's claim that he had refrained from acting.

The factual issues in this case are of the type that courts and juries customarily have been deciding in fraud cases for years: whether Bankers Trust knew that the Equity National stock was worthless, whether it misrepresented that fact to Mallis and Kupferman, and whether that conduct influenced them to accept the pledge as collateral for the loan. This case does not present the dangers and problems that led the Court in *Blue Chip* to limit suits under Rule 10b–5 to actual purchasers and sellers. *Blue Chip* thus suggests no reason to construe a pledge as anything other than a sale, and, if it is so construed, Mallis and Kupferman were actual purchasers of the stock because they received it as collateral for the loan they made.[24]

[24] The Court in *Blue Chip* also pointed out (421 U.S. at 734–735) that actual purchasers and sellers will "at least seek to base recovery on a demonstrable number of shares traded. In contrast, a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury such as loss of a non-contractual opportunity to buy or sell, is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective hypothesis." That consideration also is inapplicable here, since there is no question concerning the number of shares pledged or the amount of the loss that Mallis and Kupferman suffered.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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